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Courts as Information Intermediaries: A Case Study of Sovereign Debt Disputes

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Courts as Information Intermediaries: A Case Study of Sovereign Debt Disputes

Sadie Blanchard*

It's well known there's always two sides, if no more; else who'd go to law, I should like to know?

— George Eliot, *Middlemarch* (1872)

When foreign sovereigns default on their debt, creditors sometimes sue them. These creditors are sophisticated actors, and they know that if they sue, courts can do little to force a sovereign to satisfy a judgment. Why do they sue? This Article argues that these creditors sue because they use litigation to produce information about the debtor state or its government that induces third parties to sanction or refuse to deal with the state or the government. The ability to produce such information strengthens the litigating creditors' bargaining position in settlement negotiations. Courts thus serve as information intermediaries that strengthen reputational enforcement in the international sovereign debt market. The Article presents a case study that includes interviews with market participants and their lawyers to show three ways in which courts play this informational role. First, courts publicly determine whether a sovereign debtor has violated its legal obligations to creditors. Second, through discovery and fact finding, courts mitigate information asymmetries concerning aspects of sovereign behavior related to default that are difficult to monitor. Third, they provide a forum in which creditors

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seek to recast the broader political and ethical dimensions of disputes by highlighting corruption by the debtor state government. The sovereign debt market thus relies on a hybrid of legal and nonlegal enforcement. Parties appeal to the law to determine rights, detect bad behavior, and provide a broad normative frame. At the same time, they depend on reputation to discourage violations. This finding has implications for the debate among contracts scholars about the extent to which nonlegal mechanisms such as reputation can support trade. Recognizing that courts can function as information intermediaries implies that courts can expand the range of markets that reputation can support. Under certain conditions, courts can supplement legal remedies by transmitting accurate and credible information about market participants' expectations and behavior.

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INTRODUCTION

Contracts scholars debate the extent to which nonlegal enforcement mechanisms can support market transactions. Dispute resolution in the international sovereign debt market offers new insights into this question. Because creditors can rarely collect on judgments against foreign sovereigns, researchers studying the international sovereign debt market largely assume that law matters little to its functioning.¹ Yet creditors sometimes spend millions of dollars and many years suing sovereigns that default. Investors buy distressed sovereign debt—loans and bonds on which a sovereign has already defaulted or will imminently default—with the apparent intention of pursuing litigation to recover it. If law does not matter, why do they do this? This Article argues that the seemingly toothless right to sue debtor states supports reputational enforcement in the international sovereign debt market.

Scholars have long recognized the sovereign debt market as part of a vast terrain of commercial relationships governed by nonlegal mechanisms. In the sovereign debt literature, the dominant view is that law and courts are unimportant to sustaining sovereign lending.² Explanations for the successful operation of this market focus on reputational costs, retaliation measures such as trade sanctions, and the economic and political costs of default.³

1. See Ugo Panizza, Federico Sturzenegger & Jeromin Zettelmeyer, *The Economics and Law of Sovereign Debt and Default*, 47 J. ECON. LIT. 651, 659–64 (2009) (describing the debate in the economics literature over whether law, reputation, or nonlegal sanctions explain why sovereigns repay and how the sovereign debt market can exist).

2. In recent work, Mark Weidemaier and Mitu Gulati point out that law plays a larger role than is generally assumed in structuring the sovereign borrower-lender relationship. See W. Mark C. Weidemaier & Mitu Gulati, *The Relevance of Law to Sovereign Debt*, 11 ANN. REV. L. SOC. SCI. 395 (2015) [hereinafter Weidemaier & Gulati, *The Relevance of Law*]. Prior to their work, law was viewed as relevant only to the extent that it enables creditors to impose costs on sovereigns through legal harassment. See CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY 57 (2009); Andrei Shleifer, *Will the Sovereign Debt Markets Survive?*, 93 AM. ECON. REV. 85, 87 (2003) (“[L]enders have no power. . . . [T]here are no courts with authority over sovereign states whose mandate is to protect the interest of creditors.”).

3. See Panizza et al., *supra* note 1; Weidemaier & Gulati, *The Relevance of Law*, *supra* note 2. Carmen Reinhart and Kenneth Rogoff are the most prominent proponents of the argument that trade sanctions are a major force in incentivizing sovereigns to repay loans. See REINHART & ROGOFF, *supra* note 2, at 57. Michael Tomz, on the other hand, finds little

Some recent scholarship ascribes a more important role to law but only because, in particular, unusual recent cases, courts have implemented effective sanctions on sovereign debtors.⁴ Scholars of and practitioners in the sovereign debt market widely share the assumption that law and courts matter only to the extent that they enable confiscation of assets.⁵ Although courts offer creditors a better prospect of sanctioning debtors today than they did in the past, scholars, market participants, and lawyers who highlight the growing role of formal sanctions acknowledge that they remain weak.⁶

evidence of retaliatory trade sanctions against defaulting countries. See MICHAEL TOMZ, *REPUTATION AND INTERNATIONAL COOPERATION* 158–95 (2007).

4. See, e.g., Panizza et al., *supra* note 1, at 655–59 (surveying creditors' enforcement efforts and concluding that legal enforceability of sovereign debt remains minimal); W. Mark C. Weidemaier & Anna Gelpern, *Injunctions in Sovereign Debt Litigation*, 31 YALE J. REG. 189, 206–08 (2014) (describing the enforcement mechanism as a “court-imposed embargo” that hinders the ability of a sovereign to transact with third parties for fear of asset confiscation).

5. See Panizza et al., *supra* note 1, at 659 (“[T]he main difference between corporate and sovereign debt is the lack of a straightforward legal mechanism to enforce repayment of the latter. In the event of default, legal penalties or remedies do exist, but they are much more limited than at the corporate level. This leads to the question of why debt nonetheless tends to be repaid, and why a sovereign debt market can exist.”); REINHART & ROGOFF, *supra* note 2, at 53–58 (calling the lack of an effective legal enforcement mechanism against sovereigns “the most fundamental ‘imperfection’ of international capital markets” and describing alternative incentive devices: institutional mechanisms, defined as the threat of asset seizures abroad, and reputational mechanisms, defined as the threat of lost future access to credit). Reinhart and Rogoff equate reputational theories with the view that institutions, including courts, do not matter. See *id.* at 55–56. While Reinhart and Rogoff argue that the threat of asset seizures incentivizes debt repayment by posing a blockade risk to the country's foreign trade, they acknowledge the insufficiency of this mechanism to explain “the scale and size of international lending or the diversity of measures creditors bring to bear in real-life default situations.” *Id.* at 57.

6. See Jeremy Bulow & Kenneth Rogoff, *A Constant Recontracting Model of Sovereign Debt*, 97 J. POL. ECON. 155, 157 (1989) (“[L]enders may hold the stick of being able to impose sanctions that will impede trade and financial market transactions. However, . . . the vulnerable assets held abroad by most LDCs are trivial relative to the amounts they owe.”); Interview with Senior Sovereign Debt Lawyer I (July 12, 2017) (describing how Argentina's creditors pursued it around the world for over a decade and had some of the world's most sophisticated lawyers yet recovered very little through court enforcement, that trust structures are used to structure new debt issuances to avoid vulnerability to attachment, and that major commodity-exporting countries like Venezuela are more vulnerable to formal enforcement); Interview with Senior Sovereign Debt Professional (July 22, 2017) (stating that confiscating assets of a commodity exporting state like Venezuela is very difficult because most of the assets are owned not by the state but by a corporation that is a separate legal person).

Professionals I interviewed who have decades of experience in the sovereign debt market struggled to reconcile their conviction that the law and courts are weak and unimportant in this market with the fact that investors do indeed sue and do so aggressively at great expense. For example, one person who has worked in the secondary market of sovereign debt for decades emphasized the weakness of courts. He explained that in enforcement litigation, “no one was very successful[; i]t wasn’t the solution[,]” and discovery efforts were “a hill of beans in the end” because they did not lead to successful asset seizures.⁷ He then averred that the “threat of litigation does move mountains” and concluded, “I don’t want to leave off with litigation is worthless, useless. I think it does keep people honest.”⁸ A senior lawyer who has defended sovereigns in litigation described the legal situation starkly: “[T]he people who buy these bonds better realize they are essentially unenforceable and based on the good will of the countries. Essentially, they are unenforceable. It’s voluntary enforcement by the debtor.”⁹ These remarks seem paradoxical: how can the threat of litigation “keep people honest” when experience demonstrates that states can so effectively elude creditors?¹⁰

If much of the sovereign debt literature and many sovereign debt market participants are skeptical of courts’ effectiveness, then much of the scholarship on informal contract enforcement could be described as hostile toward courts. Informal governance is, after all, about “opting out of the legal system.”¹¹ The literature highlights the weaknesses of courts: their inability to provide adequate remedies, their tendency to apply disfavored rules and interpretive methods, their lack of commercial expertise, and their costliness.¹²

7. Interview with Senior Market Participant I (July 18, 2017).

8. *Id.*

9. Interview with Senior Sovereign Debt Lawyer VI (Aug. 22, 2017).

10. See Interview with Senior Market Participant I (July 18, 2017).

11. See Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992). In more recent work, Professor Bernstein has explored how formal contracting can “create a space in which private order can flourish.” Lisa Bernstein, *Beyond Relational Contracts: Social Capital and Network Governance in Procurement Contracts*, 7 J. LEGAL ANALYSIS 561, 561 (2015).

12. See, e.g., Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code’s Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1820 n.167 (1996); Bernstein, *Opting Out*, *supra* note 11; David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104

In this literature, adjudication usually takes the form of private arbitration, in which privately created rules are applied to decide disputes between repeat players operating in closed networks.¹³ When courts are discussed, it is usually to explain how they undermine private ordering.¹⁴ In short, neither the literature on informal contract governance nor the scholarship on sovereign debt has much explored how courts might support informal contract enforcement.¹⁵

This Article examines just that question. In light of the voluminous scholarship portraying courts and informal enforcement as alternatives, the choice by participants in the sovereign debt market to opt in to courts appears somewhat mysterious. Certain facts deepen the mystery. There are already robust

HARV. L. REV. 373 (1990) (treating “Third-Party Decisionmaking with Reputational Enforcement” as coextensive with opting out of courts; cataloguing reasons courts are unsuitable adjudicators for commercial transactions); John McMillan & Christopher Woodruff, *Private Order Under Dysfunctional Public Order*, 98 MICH. L. REV. 2421 (2000).

13. See, e.g., Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724 (2001); Bernstein, *Merchant Law*, *supra* note 12; Bernstein, *Opting Out*, *supra* note 11.

14. See Bernstein, *Merchant Law*, *supra* note 12, at 1820 n.167; Gillian K. Hadfield & Iva Bozovic, *Scaffolding: Using Formal Contracts to Support Informal Relations in Support of Innovation*, 2016 WISC. L. REV. 981, 998 (recounting interview respondents’ intentions to avoid litigation at almost any cost, despite their intensive use of formal contracts to coordinate “innovation-oriented” relationships); see also Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 541–619 (2003) (viewing informal and formal contract governance as alternatives); Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1645 (2003) (“[L]egal liability . . . may . . . ‘crowd out’ . . . self-enforcing mechanisms.”).

15. There are two recent exceptions. A study published in 2016 by Gillian Hadfield and Iva Bozovic considers the role of formal contract institutions in informal enforcement, but courts are not a focus of their study. See Hadfield & Bozovic, *supra* note 14, at 1011–12. They find that parties in “innovation-oriented” commercial relationships make intensive use of formal contracts but rely on informal enforcement, primarily through the threat of terminating an ongoing relationship. See *id.* Gilson, Sabel, and Scott examine how formal enforcement with mild sanctions might complement informal enforcement. Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377 (2010). However, courts can sanction violations of some of the obligations in their study. See *id.* In the case of sovereign debt contracts, none of the obligations can reliably be enforced with traditional remedies, though all can be adjudicated. See *id.* Sovereign bond contracts do not look like the highly relational contracts for innovation studied by Hadfield and Bozovic and Gilson, Sabel, and Scott. Similarly, Edward B. Rock has theorized reputation as a key mechanism by which the courts of Delaware discourage bad behavior by corporate executives, but his study focuses on the law of fiduciaries and corporate governance rather than contract disputes. See Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009 (1997).

institutions acting in this market to discover and disseminate information about sovereign borrowers' behavior, including the International Monetary Fund (the IMF), other multilateral financial institutions, and credit rating agencies. This Article offers a theory of what courts do that is distinctive and valuable to contracting parties in this market, adding to a nascent literature examining the role of law and courts in the sovereign debt market.¹⁶

Even though courts usually cannot enforce debtor states' obligations through conventional judicial means, they play a key role in the sovereign debt market. Courts are important players because they produce information that has the power to provoke reactions by third parties that are costly for the debtor or its agents. Creditors litigate because revealing such information through the courts strengthens a creditor's leverage in settlement negotiations. Courts serve three information-providing functions. First, when complex legal issues arise between the parties, courts determine whether the state has breached its obligations to the creditor.¹⁷ Such legal determinations affect third-party assessments of the state's riskiness as a borrower. Second, discovery and judicial fact-finding mitigate information asymmetries about debtor behavior during default and restructuring.¹⁸ Third, courts provide a platform in which creditors can recast the dispute's political and ethical implications, offering an alternative account of their own behavior and that of the debtor state's government.¹⁹ Sovereign bond enforcement thus employs a hybrid enforcement mechanism in which formal judicial process and informal, third-party sanctions interact to make reputational governance more effective.²⁰

16. See W. Mark C. Weidemaier & Mitu Gulati, *International Finance and Sovereign Debt*, in 3 OXFORD HANDBOOK OF LAW AND ECONOMICS 482 (Francesco Parisi ed., 2017) [hereinafter Weidemaier & Gulati, *Sovereign Debt*] (describing the ways contracts are relevant to sovereign debt, including in offering creditors enhanced enforcement rights and making promises that, if disappointed, would cause reputational harm); Weidemaier & Gulati, *The Relevance of Law*, *supra* note 2.

17. See *infra* Section III.A.

18. See *infra* Section III.B.

19. See *infra* Section III.C.

20. Law and economics scholarship often sharply distinguishes formal from informal enforcement and legal from nonlegal enforcement. See, e.g., Bentley MacLeod, *Reputations, Relationships, and Contract Enforcement*, J. ECON. LITERATURE 595, 596 (2007) ("When a contract uses formal enforcement, breach . . . gives the harmed party the right to appeal to an impartial third party to obtain monetary damages from the breaching party. . . . Contract law is

Part I of this Article explains the legal framework for enforcing sovereign debt obligations, which presents an unusual separation of courts' adjudicatory and enforcement functions. Part II explains how reputation operates in the sovereign debt market, analyzing how the determinants of effective reputational governance apply in this context. Part III discusses what courts add to reputation in this market and presents evidence that they serve as reputational intermediaries. The evidence includes court decisions and litigation documents, generalist and trade media reports, and interviews with industry participants.²¹ Part IV concludes with implications for the theory of sovereign debt, informal contract governance, and the role of courts in commercial disputes.

I. THE LEGAL FRAMEWORK FOR SOVEREIGN DEBT CONTRACTS

Most foreign-issued sovereign bonds contain New York forum selection clauses. This Part describes the legal framework for such bonds.²² Judgments against sovereign defaulters are hard to enforce because sovereign assets are protected by immunities and because

concerned with the question of determining whether or not a breach has occurred and, if so, what damages should be given in light of the contract that the parties have signed. In contrast, under *informal enforcement* the harmed party unilaterally decides that breach has occurred and then carries out actions that harm the reputation of the breaching party.”). MacLeod’s synthesis of the literature highlights the unilateral element of informal enforcement: even where collective action is required to punish cheaters, a party that considers itself to have been harmed has the power unilaterally to invoke collective punishment. Other scholars assume the unilateral element in informal enforcement. See DOUGLAS NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE 36–60 (1990); Avner Greif, *Cultural Beliefs and the Organization of Society: A Historical and Theoretical Reflection on Collectivist and Individualist Societies*, 102 J. POL. ECON. 912 (1994). “Formal” is often used interchangeably with “legal” and sometimes also with “public.” Likewise, scholars often toggle between “informal,” “nonlegal,” and “private.” See ROBERT ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 127 (1991) (defining “law” as rules enforced by governments rather than through social means); Barak D. Richman, *Firms, Courts, and Reputation Mechanisms*, 104 COLUM. L. REV. 2328, 2330 (2004). Other scholarship is more precise. See BARAK D. RICHMAN, STATELESS COMMERCE 12–13 (2017); Gillian K. Hadfield & Barry R. Weingast, *Law Without the State*, 1 J. L. & CTS. 3 (2013).

21. Twenty interviews were conducted by telephone between May and September 2017 with professionals with substantial experience in the aspects of sovereign debt discussed here. Further description of the interviews is in the Appendix. Records of the interviews are on file with the author.

22. London and U.K. law are the second most common choices of forum and law for foreign-issued sovereign debt. See MITU GULATI & ROBERT E. SCOTT, THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN 54 (2012). The aspects of the law relevant to this analysis are substantially the same.

sovereigns do not keep assets where they are vulnerable to seizure. Sovereigns have two types of immunity from the power of foreign courts: jurisdictional and executorial immunity. Jurisdictional immunity has largely been eliminated for sovereigns when they act in a commercial capacity, such as when they issue bonds.²³ Immunity from execution against sovereign assets, however, remains largely in place. Bonds that submit disputes to New York courts typically waive both jurisdictional and executorial immunity with respect to courts in New York.

In the United States, the Foreign Sovereign Immunities Act (FSIA) permits courts to attach sovereign assets that are located in the United States, commercial in nature, and connected to the dispute under adjudication.²⁴ Assets of a public nature are immune. In a dispute concerning a sovereign bond, and in many disputes concerning bank borrowing by foreign states, there will typically be no assets located in the United States that are connected to the dispute. If the contract waives immunity from execution, however, a New York court can reach all of the sovereign's *commercial* assets that are in the United States.²⁵

For most sovereigns, even this broader formulation leaves few to no vulnerable assets in the United States.²⁶ Therefore, some

23. 28 U.S.C. § 1605(a) (2012) (providing that states benefit from no immunity from jurisdiction if either (a) they have waived their immunity or (b) the action is based on a commercial activity conducted in or directly affecting the United States); *Republic of Arg. v. Weltover, Inc.*, 504 U.S. 607 (1992). Outside the United States, the dominant view is that sovereigns do not enjoy jurisdictional immunity for their commercial activities. See HAZEL FOX, *THE LAW OF STATE IMMUNITIES* 222 (2d ed. 2008). For an overview of the history of sovereign immunity law as it relates to sovereign debt, see Curtis A. Bradley & Laurence R. Helfer, *International Law and the U.S. Common Law of Foreign Official Immunity*, 2010 SUP. CT. REV. 213, 219; Weidemaier & Gulati, *The Relevance of Law*, *supra* note 2, at 398. For recent developments, see Lorenza Mola, *Sovereign Immunity, Insolvent States and Private Bondholders: Recent National and International Case Law*, 11 L. & PRAC. INT'L CTS. & TRIBUNALS 525, 534, 536 (2012).

24. 28 U.S.C. § 1610 (2012).

25. W. Mark C. Weidemaier, *Sovereign Immunity and Sovereign Debt*, 2014 U. ILL. L. REV. 67, 92.

26. An exception is where the sovereign is making payments on other bonds through a fiscal agent located in New York. In that case, creditors might be able to attach payments to other bondholders when they are in possession of the fiscal agent. It is possible to use a trust structure to avoid this outcome. Interview with Senior Sovereign Debt Lawyer I (July 12, 2017). Additionally, courts have, in some cases, declined applications to order injunctive relief that would interfere with the issuance of new debt or restructuring of existing debt, so this enforcement mechanism is not guaranteed. The Republic of Congo, for

bonds also submit to jurisdiction and waive immunity before all other courts in the world, but only for actions to enforce a New York court judgment concerning the bond. Such provisions permit investors to pursue sovereign assets, wherever in the world they may be. Thus, they appear on their face to offer creditors a strong enforcement mechanism. Without global submission to jurisdiction and waiver of executorial immunity, only rarely can a court outside New York enforce a New York court judgment. But even with such a waiver, foreign courts exercise only limited coercive power because waivers are construed narrowly, either by judicial interpretation or because of statutory limits on their scope. Additionally, sovereigns avoid holding vulnerable assets in jurisdictions where they might be seized.²⁷

Because of all these constraints, sovereign bond judgment creditors have had very little success enforcing judgments, even under the broadest of waivers. Sovereign bonds have therefore long exhibited the odd feature of offering creditors access to adjudication but not meaningful formal enforcement.²⁸ Early modern bonds contained the starkest iteration of this apparent paradox: from the late 1970s until the mid-1990s, nearly all bonds contained waivers of jurisdictional immunity but hardly any waived executorial immunity.²⁹ From the mid-1990s until the early 2000s, many bonds contained broad waivers of jurisdictional and enforcement immunity that, as described above, appeared on their

instance, was able to issue new debt in London while it had an outstanding judgment there. Interview with Senior Sovereign Debt Professional (July 22, 2017); *see also* *Rossini v. Republic of Arg.*, 453 F. App'x 22, 22–25 (2d Cir. 2011) (affirming trial court's denial of requests for preliminary injunctions enjoining Argentina from issuing bonds); *Capital Ventures Int'l v. Republic of Arg.*, 443 F.3d 214, 221–22 (2d Cir. 2006) (discussing trial court's denial of request for an injunction on the grounds that the injunction would have interfered with a bond exchange offer).

27. Countries that export commodities are the most vulnerable to asset seizure. Interview with Senior Sovereign Debt Lawyer I (July 12, 2017). Venezuela scrupulously paid its external debt in the face of dire economic conditions because it feared seizure of its oil assets. *Id.*

28. A concerted effort by states in the second half of the twentieth century sought to formalize governance of sovereign borrowing and led to the inclusion in bond contracts of submission to formal enforcement. However, legislatures and courts proved reticent about taking coercive actions against foreign sovereigns. Therefore, sovereign bond contracts for several decades contained dispute resolution provisions that allowed creditors to get into court to litigate on the merits but offered them little prospect of recovery.

29. Weidemaier, *Sovereign Immunity*, *supra* note 25, at 87.

face to permit creditors to pursue enforcement in multiple jurisdictions. There has been a rollback of submission to courts for enforcement purposes in recent bonds: some states have eliminated the worldwide immunity waiver from their bonds, limiting creditors to New York courts.³⁰

Bondholders recently achieved one major, but fleeting, enforcement success. Courts in Brussels and New York read a term—known as the *pari passu* provision—in Argentine sovereign bonds to require Argentina to pay holdout creditors whenever it paid creditors that had accepted Argentina's offer to restructure its debt.³¹ That interpretation permitted a New York court to enjoin Argentina from paying restructured creditors unless it also paid holdouts. The injunction forced Argentina back into default. However, this "ratable payments" interpretation is unlikely to hold sway for long. The Second Circuit decision stated emphatically that the interpretation was "an exceptional one with little apparent bearing on transactions that can be expected in the future."³² Moreover, a number of courts in other jurisdictions have rejected the interpretation;³³ the official sector has lobbied vigorously against the interpretation;³⁴ only a minority of outstanding bonds

30. Compare Republic of Argentina, Prospectus, Registration No. 333-216627, at xi–xii (Mar. 14, 2017), with the text of the bonds at issue in the litigation concerning Argentina's 2001 default. The immunity waiver from the earlier bonds is quoted in published opinions from the litigation. See, e.g., *NML Capital Ltd. v. Republic of Arg.* [2011] UKSC 31, [58]–[60] (on appeal from [2010] EWCA (Civ) 41).

31. See Stephen J. Choi, Mitu Gulati & Robert E. Scott, *The Black Hole Problem in Commercial Boilerplate* 16–40 (N.Y. Univ. Sch. of Law Public Law and Legal Theory Research Paper Series, Working Paper No. 16-40, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2835681. A Belgian court had issued a similar ruling against Peru in 1999. See Hof van Beroep [HvB] [Court of Appeal] Brussel, Sept. 26, 2000, AR No. 2000/QR/92 (Belg.).

32. *NML Capital, Ltd. v. Republic of Arg.*, 727 F.3d 230, 247 (2d Cir. 2013). The court continued,

Our decision here does not control the interpretation of all *pari passu* clauses or the obligations of other sovereign debtors under *pari passu* clauses in other debt instruments. As we explicitly stated in our last opinion, we have not held that a sovereign debtor breaches its *pari passu* clause every time it pays one creditor and not another, or even every time it enacts a law disparately affecting a creditor's rights.

Id.

33. See FEDERICO STURZENEGGER & JEROMIN ZETTELMEYER, *DEBT DEFAULTS AND LESSONS FROM A DECADE OF CRISES* 70–71 (2006).

34. See Choi, Gulati & Scott, *supra* note 31, at 17.

contain the language on which the interpretation was based;³⁵ and recent bonds have been drafted to defang *pari passu* provisions.³⁶

The difficulty of enforcing judgments would not have been a surprise to bond purchasers. Sophisticated banks and investment firms, which have largely dominated this market, factor the legal framework into their risk models.³⁷ Prospectuses of bonds issued in New York include disclosures about the bonds' limited enforceability.³⁸

Successfully suing a sovereign debtor, therefore, offers little prospect of recovery through conventional means. This is especially true of pre-1990 bonds and recent bonds that submit only to the courts of New York. Even if the sovereign has substantial commercial assets in the United States, it can remove vulnerable assets from U.S. territory in anticipation of default or litigation, structure its holding of commercial assets so that they are not considered sovereign assets, and structure new debt issuances to make it impossible for judgment creditors to attach their proceeds.³⁹

35. See GULATI & SCOTT, *supra* note 22.

36. See Choi, Gulati & Scott, *supra* note 31, at 30 (finding that as of the second quarter of 2016, bonds comprising nearly seventy percent of dollar value of offerings during that quarter had revised the *pari passu* language to avoid the ratable payments interpretation).

37. Institutional investors model the legal terms of bonds when calculating their riskiness. Interview with Investment Analyst (May 28, 2017). Legal terms are present in the bonds of risky but not those of riskless sovereigns, and the terms change in response to political risk shocks. Stephen J. Choi, Mitu Gulati & Eric A. Posner, *The Evolution of Contractual Terms in Sovereign Bonds*, 4 J. LEGAL ANALYSIS 131, 131 (2012). Sovereign immunity and dispute resolution provisions, in particular, vary across issuers and over time for individual issuers and, unlike the *pari passu* provisions, display differences and changes that clearly alter the parties' legal rights. Compare, for example, Argentina's bonds from the 1990s to its more recent bonds. See also *id.*; W. Mark C. Weidemaier, *Disputing Boilerplate*, 82 TEMP. L. REV. 1 (2009); Weidemaier & Gulati, *The Relevance of Law*, *supra* note 2, at 397–400. See generally Weidemaier & Gulati, *Sovereign Debt*, *supra* note 16.

38. See, e.g., Offering Circular, The Republic of Ecuador, U.S. \$1,000,000,000, 10.750% Notes Due 2022, at 25–26 (July 28, 2016); United Mexican States, Pre-effective Amendment No. 3 to Registration Statement Under Schedule B of the Securities Act of 1933, Registration No. 333-167916, at S-9 (Sept. 2, 2010), <https://www.sec.gov/Archives/edgar/data/101368/000119312510203668/dsba.htm#toc>.

39. See *First Nat'l City Bank v. Banco Para El Comercio Exterior de Cuba*, 462 U.S. 611, 628 (1983) (establishing a “presumption that a foreign government’s determination that its instrumentality is to be accorded separate legal status” will be respected); *Walters v. Indus. & Commercial Bank of China, Ltd.*, 651 F.3d 280, 298 (2d Cir. 2011) (establishing a presumption that assets of a state-owned company cannot be used to satisfy a judgment against the state). But see *Bridas S.A.P.I.C. v. Gov’t of Turkm.*, 345 F.3d 347 (5th Cir. 2003)

To be sure, avoiding holding assets in or routing them through the United States is not costless. A creditor facing an outstanding judgment in New York might not be able to issue securities on the New York Stock Exchange because proceeds might be subject to enforcement, though New York courts have declined to grant creditor requests that would prevent new debt issuance.⁴⁰ Transactions must be structured so as to avoid placing commercial property owned by the sovereign within the United States.⁴¹

However, the experience of the creditors that held out against Argentina demonstrates the low prospects of achieving satisfaction of a judgment against a sovereign debtor in the United States. U.S. law is strongly protective of foreign sovereign assets.⁴² Unlike the laws of many European countries, the FSIA irrevocably shields assets of a public nature. Under the FSIA, even a broad immunity waiver only applies to commercial assets.⁴³

A sovereign that submits to enforcement in all jurisdictions faces higher litigation-related costs. In addition to legal expenses to avoid creditors, it might have to remove assets from many jurisdictions that offer commercial and investment opportunities. It might also face higher costs of engaging in international transactions and collecting taxes from entities located abroad. However, attachment of sovereign assets by bond creditors is vanishingly rare. Creditors can use court orders to throw sand in the gears of a defaulting country's trade and finance. But

(holding that a directly state-owned enterprise can be held to be the state's alter-ego where failing to do so would allow "fraud or injustice").

40. See *Rossini v. Republic of Arg.*, 453 F. App'x 22, 22-25 (2d Cir. 2011) (affirming trial court's denial of requests for preliminary injunctions enjoining Argentina from issuing bonds); *Capital Ventures Int'l v. Republic of Arg.*, 443 F.3d 214, 221-22 (2d Cir. 2006) (discussing trial court's denial of request for an injunction on the grounds that the injunction would have interfered with a bond exchange offer).

41. See Bulow & Rogoff, *supra* note 6, at 158-59. A specialized legal practice has arisen to advise sovereigns and third parties contracting with them on how to structure transactions to avoid having payments subject to enforcement litigation. See Kenneth Reisenfeld, Mark Cymrot & Joshua Robbins, *Suits Against Foreign Sovereigns: Mixed Bag for Energy Cos.*, LAW360 (Jan. 17, 2017), <https://www.law360.com/articles/881735/suits-against-foreign-sovereigns-mixed-bag-for-energy-cos>.

42. See Jill E. Fisch & Caroline M. Gentile, *Vultures or Vanguard?: The Role of Litigation in Sovereign Debt Restructuring*, 53 EMORY L.J. 1043, 1078, 1086 (2004) (cataloguing the failures of judgment creditors' attempts to collect against sovereign bond defaulters in the United States).

43. 28 U.S.C. § 1610 (2012).

experience shows that courts are loath to do so and are often circumvented when they do.⁴⁴ Scholars who have written about litigation emphasize these costs.⁴⁵ However, in practice, even when bondholders are empowered to pursue enforcement worldwide, they rarely succeed in attaching sovereign assets.⁴⁶ This observed fact demonstrates the weakness of the threat of attachment. Sometimes the debt is so small that early settlement is preferable to the expense of extended litigation.⁴⁷ However, on other occasions, the amounts at stake are orders of magnitude greater than either the legal costs that can be imposed on a debtor through litigation or the stock of assets vulnerable to seizure.⁴⁸ Conventional remedies and litigation-related costs therefore are not powerful enough to entirely explain why creditors sue and why investors lend. A key role of courts in this domain is as information intermediaries that strengthen reputational enforcement.

44. See *supra* notes 26–27. A bill introduced in Congress in 2011 that sought to bar foreign states facing sizeable U.S. court judgments from issuing new debt on U.S. markets was unsuccessful. Creditors have in some cases interfered with new debt issuances. See *supra* notes 31–32 and accompanying text. Sovereigns whose economies rest heavily on international trade in commodities are the most vulnerable but can elude creditors by trading through separate corporate entities or concealing their ownership of assets through straw companies. Interview with Senior Sovereign Debt Professional (July 22, 2017); Interview with Senior Sovereign Debt Lawyer I (July 12, 2017).

45. See REINHART & ROGOFF, *supra* note 2, at 56–57.

46. Michael Tomz & Mark L.J. Wright, *Empirical Research on Sovereign Debt and Default*, 5 ANN. REV. ECON. 247, 262 (2013). In the more than ten years of litigation against Argentina before the *pari passu* ruling and related injunction, its holdout creditors pursued it in courts around the world with very little success in attaching assets.

47. Media reports indicate that the litigating creditors recovered less than \$200 million through formal enforcement, under four percent of the \$4.6 billion for which these creditors ultimately settled with Argentina. See Hilary Burke, *Funds to Seize Argentina Assets Held in U.S.*, REUTERS (July 20, 2012), <https://www.reuters.com/article/argentina-debt-funds/funds-to-seize-argentine-assets-held-in-u-s-idUSL2E8IK8U920120720>; *Caught Napping*, ECONOMIST (Oct. 13, 2012), <https://www.economist.com/the-americas/2012/10/13/caught-napping>; Michael D. Goldhaber, *An Infamous Bet*, AM. LAW. 48, 50 (Oct. 2016), <http://www.americanlawyer-digital.com/americanlawyer-ipauth/201610flaip?pg=48#pg48>; Julie Wernau & Taos Turner, *Argentina Debt Deal Poised to Deliver Big Payday to Holdouts*, WALL STREET J. (Feb. 29, 2016), <https://www.wsj.com/articles/argentina-holdout-creditors-agree-to-4-65-billion-settlement-1456760652>.

48. See Weidemaier & Gelpern, *supra* note 4, at 194; Interview with Senior Sovereign Debt Lawyer II (July 19, 2017) (discussing a case he worked on in which the debtor state had almost no assets outside its territory but was concerned about litigation).

II. REPUTATION IN THE SOVEREIGN DEBT MARKET

The extent to which a market relies on informal versus formal enforcement depends on the relative costs of each for incentivizing optimal compliance with contracts. The effectiveness of reputation and the mechanism by which it operates depend largely on two dimensions of information costs: the cost of producing credible and relevant information about traders, and the cost of transmitting that information to prospective counterparties. Information costs, together with the value of lost future transactions, determine the cost of cheating.

The sovereign debt market exhibits some features that make it amenable to reputational governance and others that hinder reputation from operating effectively. The reputation-supporting features are substantial. Sovereign borrowers are about as far from anonymous as a commercial entity can be and are subject to significant scrutiny by the press and other information-reporting institutions. These characteristics lower the costs of disseminating information about default behavior, not only to bond market participants but also to actors in other fields in which sovereigns operate. In addition, sovereigns have a long time horizon⁴⁹ and few alternative opportunities that are shielded from the effects of reputation in the sovereign debt market. These factors increase the cost of compromising future transactions by incurring reputational damage. Against the characteristics tending toward effective reputational enforcement, high monitoring and verification costs pose the greatest barrier to effective reputational governance.

A. Information Dissemination Costs

Reputation's effectiveness increases as information about past behavior spreads more widely among potential counterparties.⁵⁰

49. See *infra* notes 54–56 and accompanying text for a discussion of the time horizons of sovereigns and the time horizons of governments.

50. This is a key lesson from the literature on informal governance. Much of the value of closed and quasi-closed networks is the inability to escape one's past. See Lisa Bernstein, *Contract Governance in Small World Networks: The Case of the Maghribi Traders*, NW. U. L. REV. (forthcoming 2019) [hereinafter Bernstein, *The Case of the Maghribi Traders*]; Bernstein, *Opting Out*, *supra* note 11; Avner Greif, *Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition*, 83 AM. ECON. REV. 525 (1993); Janet T. Landa, *A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law*, 10 J. LEGAL STUD. 349 (1981).

Contemporary sovereign debt defaults are highly visible events. They are front-page news, not only in industry trade publications but also in mainstream newspapers. Today, most sovereign debt takes the form of bonds. Unlike in the past, when most sovereign debt consisted of syndicated loans from a small number of highly sophisticated banks, modern bonds are often held by dispersed creditors or by institutions that manage the assets of masses of investors, which draws public attention to default events. Defaults often occur during times of economic crisis, when scrutiny of the defaulting sovereign is high. Credit rating agencies and the IMF report on sovereign borrowers' behavior during restructuring negotiations,⁵¹ and both regulation and custom dictate that sovereigns include information about previous defaults in their prospectuses.⁵²

Sovereign defaults thus result in the widespread dissemination of information about the facts of a default, the time spent in default, levels of creditor recovery, and treatment of creditors during default and restructuring.

B. The Value of Lost Future Transactions

The threat of a tarnished reputation is only as strong as the value of the future transactions it jeopardizes. The value of lost future trade depends, to a large extent, on how widely word spreads about bad behavior, and as discussed above,⁵³ sovereign defaults are no secret. Further, sovereigns face an effectively infinite time horizon and costly reputation spillovers beyond the

51. See, e.g., IMF, *Dominica: Second Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criterion*, Country Report No. 04/286, at 11–12 (Sept. 2004) [hereinafter IMF, Country Report No. 04/286] (“The authorities have followed best practices in implementing the debt restructuring exercise (i.e., transparency, creditor consultations, and inter-creditor equity). They approached creditors at an early stage, while continuing to service fully their obligations under the program”); cf. Daniel B. Klein, *Promise Keeping in the Great Society: A Model of Credit Information Sharing*, 4 ECON. & POL. 117 (1992).

52. See, e.g., Republic of Argentina, Prospectus (Mar. 14, 2017), *supra* note 30. SEC rules require the disclosure of this information for debt issuances to retail investors, but even prospectuses for issues to Qualified Institutional Buyers, which are exempt from those disclosures, often include them.

53. See *supra* Section II.A.

bond market. Together, these factors tend to raise the stakes of incurring reputational damage.

Most theories of sovereign borrower reputation assume perfect information and a unitary state with an infinite time horizon.⁵⁴ While sovereigns have an effectively infinite time horizon, governments do not. Governments of democracies that default on debt might be punished politically because of the economic damage resulting from default.⁵⁵ Some governments, therefore, have incentives to behave like actors with long time horizons. On occasion, however, governments that default are rewarded politically.⁵⁶ Theories of sovereign borrower reputation with more realistic assumptions and stronger predictive power account for a non-unitary state, changing government, learning by investors, and different reputational consequences resulting from opportunistic as compared to non-opportunistic default.

Michael Tomz's reputational theory of the sovereign debt market accounts for investors' limited information and their ability to learn about sovereigns' political preferences by observing political change and behavior. Tomz offers strong empirical support for this theory.⁵⁷ He shows that investors consider not only whether a sovereign has defaulted but also why it has defaulted. Recognizing that creditors care about the reasons for default is key to understanding the role of courts in sovereign debt disputes.

Creditors have incomplete information and the capacity to learn about governments' changeable preferences. Reputations consist of types, and Tomz identifies creditors' classifications of

54. See TOMZ, *supra* note 3, at 10–13. Tomz describes standard reputational theories that assume that borrowers have complete information about sovereign lenders' preferences and that those preferences are static. Such assumptions necessarily rest on the assumptions that the sovereign is a unitary entity with a single set of preferences rather than a complex organization with leadership that changes over time.

55. See *infra* notes 84–86 and accompanying text; Kenneth A. Schultz & Barry R. Weingast, *The Democratic Advantage: Institutional Foundations of Financial Power in International Competition*, 57 INT'L ORG., Winter 2003, at 3, 5, 13–14.

56. Rafael Correa campaigned for Ecuador's presidency on a debt repudiation platform, won, defaulted, and was reelected despite the economic harm the default caused to the country. See Arturo C. Porzecanski, *When Bad Things Happen to Good Sovereign Debt Contracts: The Case of Ecuador*, 73 L. & CONTEMP. PROBS. 251 (2010). Similarly, Argentina's Kirchner government used its stance against so-called vulture creditors as a key component of its populist appeal for over ten years.

57. See TOMZ, *supra* note 3, at 9–14.

sovereign borrowers as *lemons* that always default, *fair-weather*s that default when times are bad, or *stalwarts* that always repay.⁵⁸ Investors learn about types by observing countries' decisions whether to repay in light of prevailing economic circumstances.⁵⁹ They update their beliefs in response to new information.⁶⁰ Grossman and Van Huyck similarly model investors as "differentiat[ing] excusable defaults, which are associated with implicitly understood contingencies, from unjustifiable repudiation."⁶¹

Under Tomz's theory, a country's reputation changes when it acts contrary to its perceived type, which usually reflects political change.⁶² Investors' beliefs about states' preferences regarding repayment affect their willingness to lend and the yield they demand.⁶³ Past behavior affects future investment decisions because of what it reveals about likely future behavior.

The sovereign bond market is unlike the archetypal reputation-governed market described in the literature on informal contracting.⁶⁴ It is not a small, close-knit community, or even a closed network. Its size and openness would seem to make coordinating collective retaliation more costly and undermine efforts to ostracize cheaters. Neither Tomz's nor Grossman and Van Huyck's models involve investor retaliation or collusion. Governments know how investors view reputation and decide whether to default or repay based on the costs of each.⁶⁵ Empirical studies have found evidence suggesting that sovereign bond investors do not retaliate against past defaulters.⁶⁶ Instead, the evidence points to defaulters paying a risk premium, but not

58. *Id.* at 17, 23. One-third of sovereign defaults occur during good times. Michael Tomz & Mark L.J. Wright, *Do Countries Default in "Bad Times"?*, 5 J. EUR. ECON. ASS'N 352, 355 (2007).

59. TOMZ, *supra* note 3, at 17.

60. *Id.* at 18.

61. Herschel I. Grossman & John B. Van Huyck, *Sovereign Debt as a Contingent Claim: Excusable Default, Repudiation, and Reputation*, 78 AM. ECON. REV. 1088, 1097 (1988).

62. TOMZ, *supra* note 3, at 18–19.

63. *Id.* at 23–25.

64. See *supra* notes 11–14, 20, 50 and accompanying text. See also JANET TAI LANDA, *ECONOMIC SUCCESS OF CHINESE MERCHANTS IN SOUTHEAST ASIA: IDENTITY, ETHNIC COOPERATION AND CONFLICT* (2016); Bernstein, *The Case of the Maghribi Traders*, *supra* note 50.

65. TOMZ, *supra* note 3, at 25–27; Grossman & Van Huyck, *supra* note 61 at 1090–95.

66. See TOMZ, *supra* note 3, at 5–6.

punitive, excess returns.⁶⁷ While default has been found to block market access for a period, there is no indication that the barriers to access involve collective action rather than resulting from uncoordinated market forces. That is, when defaulters lose market access, it is because investors are unwilling to offer credit at a rate acceptable to the sovereign because of the latter's extreme riskiness.⁶⁸

Ostracism is not necessary to effectively sanction a breacher as long as credible reputational information is widely available to market participants and future transactions are more valuable than the gain from cheating now. Prominent examples of reputational governance described in the informal contracting literature that seem to hinge on ostracism look different on closer examination. Avner Greif, for instance, describes the Maghribi traders as ostracizing suspected norm violators.⁶⁹ However, even without ostracism, a trader's bad reputation, if spread widely enough, would impose costs by reducing his pool of counterparties and permitting them to demand a risk premium. The key to the Maghribis' effective reputational enforcement is that it was common knowledge that news of bad behavior would be widely disseminated. Bernstein shows in a new study of the Maghribis that a great deal of the value of their network lay in the provision of information and the ability to verify it by triangulation using several sources.⁷⁰ Her findings suggest that ostracism played a smaller role in governance than has been assumed. Instead, letters were filled with detailed information about events at various trade nodes, including verifiable facts at a granular level, such as market prices on certain dates and when ships arrived and departed from port. What closed-network governance offers of most significance is not the prospect of collective shunning but the inescapability of past behavior. The lower the proportion of prospective counterparties a cheater expects will learn of his behavior, the less likely he

67. Tomz & Wright, *supra* note 58.

68. TOMZ, *supra* note 3, at 196–219.

69. Greif, *supra* note 50. Some historians have argued that the evidence does not support the claim that the Maghribis practiced ostracism. Jeremy Edwards & Sheilagh Ogilvie, *Contract Enforcement, Institutions, and Social Capital: The Maghribi Traders Reappraised*, 65 ECON. HIST. REV. 421, 441–42 (2012).

70. See Bernstein, *The Case of the Maghribi Traders*, *supra* note 50.

is to expect sanctions, and the more likely he is to cheat. The technologies that disseminate knowledge of sovereign debtors' behavior assure all parties in the sovereign debt market that nonpayment and information about the reasons for nonpayment will be publicized.⁷¹

Spillover effects in other social fields raise the cost of cheating. For the governments that make decisions about whether to repay creditors, spillover effects threaten three key fields beyond the sovereign debt market: foreign direct investment and international trade, international relations, and domestic politics. Various aspects of reputation operate with differing force, and sometimes push in different directions, in each of these fields. Earning a reputation for opportunism or promise breaking through a dispute with foreign bondholders hurts reputation most in the bond market and foreign direct investment, but it might worsen or improve a government's reputation in the short run in domestic politics and with some other states. Defaulting on foreign-issued debt discourages foreign direct investment—which dollar-for-dollar is more beneficial to a country than debt—because foreigners worry about having their assets seized or being otherwise devalued by state action.⁷² Defaulting might hurt the country's international trade by making short-term trade credit unavailable because of heightened political risk.⁷³

A defaulting state faces the prospect of sanctions in its relations with other sovereigns and multilateral financial institutions. Unlike in the private sector, reputational governance in the official sector is partly driven by concerted action. States have faced, for instance, threats of loan and aid denials from the multilateral development and lending institutions, as well as suspension of trade benefits, for

71. *See id.*

72. *See* REINHART & ROGOFF, *supra* note 2, at 31, 58 (describing how defaulting reduces foreign direct investment); Interview with Senior Sovereign Transaction Lawyer (Aug. 14, 2017) ("A lot of investment, particularly infrastructure investment, requires lending. You have to get lenders to lend to the country. Lenders are generally uncomfortable lending into a defaulted sovereign, one that has a reputation for interfering or not honoring loans. Default . . . [also often] prevents payments by private sector borrowers because [it] affects foreign exchange. . . . [Y]ou're reluctant to finance to or in that country.").

73. Interview with Senior Sovereign Transaction Lawyer (Aug. 14, 2017).

refusing to pay arbitration awards.⁷⁴ Opportunism in relations with foreign creditors tends to harm reputation with states that value the rule of law and with the multilateral financial institutions, such as the IMF, the World Bank, and the Inter-American Development Bank, whose decision-making is powerfully influenced, if not controlled, by those states.

However, other factors tend against public-sector sanctioning of sovereign debtors that default. Aggressive creditors also face reputational risk with the same public-sector actors listed above because public-sector actors value global financial stability, poverty alleviation, and their reputations for promoting those goals. International public-sector actors sometimes judge the legal rights of particular creditors to be at odds with these other values. Moreover, non-Western states now control a large proportion of global capital and might offer alternative potential funding sources. Those states' willingness, in order to advance political goals, to provide funds in spite of a country's poor reputation for repayment eases reputational pressure on states that, in the past, would have faced ostracism in international public-sector lending.⁷⁵

Further, a sovereign that earns a reputation for promise breaking and law defiance risks incurring a fundamental reputation problem across social fields that is more difficult to ameliorate than a reputation for economic mismanagement. Whereas the latter can be offset, to some extent, by committing to implement different policies, the former undermines a sovereign's, and a government's, very power to promise. A reputation for promise breaking can hardly be mitigated through additional promises.⁷⁶ Therefore, sovereigns should be protective of their reputation for keeping promises.

Finally, given the heterogeneity of preferences of actors in the three social fields described above, creditors can strengthen the reputational threat to recalcitrant governments by uncovering or

74. See Charles N. Brower, Sadie Blanchard & Charles B. Rosenberg, *International Development Loans and Non-compliance with Investment Arbitration Awards*, in *A REVOLUTION IN THE INTERNATIONAL RULE OF LAW: ESSAYS IN HONOR OF DON WALLACE, JR.* 529 (Borzu Sabahi et al. eds., 2014).

75. Interview with Senior Sovereign Transaction Lawyer (Aug. 14, 2017).

76. See Weidemaier & Gulati, *Sovereign Debt*, *supra* note 16, at 486–87; Rachel Brewster, *Unpacking the State's Reputation*, 50 HARV. INT'L L.J. 231 (2009).

highlighting behavior by the government that is viewed negatively by third parties with power to sanction the state, even if that behavior is not part of the core dispute.⁷⁷ This ability of creditors to leverage information tangential to the central legal dispute, but central to the concerns of other potential transactors with the sovereign, expands the scope of reputational enforcement to cover cases in which agents of the state would not be punished, and might even be rewarded, for violating debt obligations.

C. Monitoring and Verification Costs

However effectively reputation channels broadcast information that threatens to jeopardize breachers' future transactions, information dissemination cannot support trade if the information is not sufficiently trusted or if signals are excessively noisy. Hurdles to trust in information regarding sovereign bond defaults include high monitoring and verification costs and heterogeneous preferences among market participants.

The kind of information that is relevant to sovereign reputation depends on what the relevant audiences care about. As explained above,⁷⁸ creditors consider not only whether a sovereign has defaulted but also why it has defaulted. They distinguish defaults they deem justifiable from unjustifiable debt repudiation.⁷⁹ Investors therefore care about aspects of default about which the truth is not easily ascertained, such as whether the default was opportunistic or necessary. They also care about whether default was caused by external shocks or economic mismanagement⁸⁰ and about how the state treats creditors in the event of default. As a senior sovereign debt lawyer explained,

77. Cf. TOMZ, *supra* note 3, at 7–9 (discussing the related concept of “issue linkage”).

78. See *supra* notes 55–68 and accompanying text.

79. See TOMZ, *supra* note 3, at 17, 23; Grossman & Van Huyck, *supra* note 61. One-third of sovereign defaults occur during good times. Tomz & Wright, *supra* note 58, at 355.

80. See ODETTE LIENAU, *RETHINKING SOVEREIGN DEBT* 57–99 (2014) (describing investors' willingness to lend to even recently defaulting states when they judge the default to have been justified). Interviewees also explained that market participants care about the reason for a default and how it was handled. Interview with Senior Sovereign Debt Lawyer I (July 12, 2017); Interview with Investment Analyst (May 28, 2017). Reinhart and Rogoff argue that “willingness to pay rather than ability to pay is typically the main determinant of country default.” REINHART & ROGOFF, *supra* note 2, at 54.

What the market remembers more than the fact of a debt restructuring is the professionalism with which it's done. If you do it like Argentina, where the politicians are able to make a huge political, populist point about fighting the vultures and so forth, the market remembers that. Uruguay restructured in 2003; did it very maturely. The market rewarded it, and Uruguay was able to do a wholly voluntary issuance.⁸¹

Much of the sovereign's decision-making that affects its ability to repay, its decision whether to repay, and how to restructure cannot be perfectly monitored because of high exogenous risk and the complexity of the economic, financial, and political factors that affect ability to pay.⁸² Creditors cannot perfectly monitor the value of the resources available for payment, so it is difficult to discern whether a restructuring offer is a good deal or a bad one.

Some interview subjects remarked that the market has a short memory. They therefore questioned how strong of a threat reputation poses.⁸³ Statistical evidence, however, shows that sovereigns that are expected to default pay more on average for capital, that sovereigns that default in defiance of market expectations faced increased borrowing costs, and that sovereigns that establish a record of diligent repayment reduce their borrowing costs.⁸⁴ Further, reputation during default should be considered separately from reputation at the time of future debt offerings. Even if the market were quick to forgive a defaulter once it has settled with creditors, a belief by holdout creditors that the state is dealing unfairly and understating its ability to pay lengthens the time in default. This, in turn, increases the harm to the country from defaulting. As long as a sovereign remains in

81. Interview with Senior Sovereign Debt Lawyer I (July 12, 2017).

82. Cf. Abhijit V. Banerjee & Esther Dufo, *Reputation Effects and the Limits of Contracting: A Study of the Indian Software Industry*, 115 Q.J. ECON. 989 (2000) (finding that Indian software firms develop a reputation for remediation, which they can control, rather than quality alone because quality is poorly correlated with performance); MacLeod, *supra* note 20 (showing that warranty contracts lower the cost of informal enforcement as compared to standard sales contracts because of imperfect correlation between performance and quality).

83. Interview with Senior Market Participant I (July 18, 2017).

84. TOMZ, *supra* note 3.

default,⁸⁵ its credit ratings remain low, further sovereign borrowing is expensive or impossible, and nongovernmental sectors are negatively affected.⁸⁶ Even if investors' memories are short once a default is cured, reputation can deter cheating when information is disseminated widely if present reputation, by preventing a state from curing default, causes sufficient harm during the period of default.

The rest of this Part describes the information provided about sovereign borrowers by two key information intermediaries operating in the sovereign debt market: multilateral official lending institutions and credit rating agencies. It also explains why investors view those institutions as having limited reliability as reputation verifiers.

1. Multilateral official lending institutions

Public-sector multilateral lending institutions, such as the IMF and the Inter-American Development Bank, monitor and report on the behavior of sovereigns, including sovereign borrowers.⁸⁷ The information they provide probes deeply into the core issues of willingness versus ability to pay, the competence of economic management, and the impact on a debtor country of exogenous shocks. The IMF monitors and disseminates information relevant to sovereign behavior under two ongoing monitoring programs and engages in more intensive monitoring of countries that borrow from the IMF. The first program, Article IV bilateral surveillance, is continuous monitoring of and annual reporting on all member countries, which assesses economic and financial policies that affect the country's stability, including exchange rate; monetary, fiscal, and financial sector; and structural policies.⁸⁸ Bilateral surveillance also includes assessments of "inward spillovers," or global

85. Udaibir S. Das, Michael G. Papaioannou & Christoph Trebesch, *Sovereign Debt Restructurings 1950–2010: Literature Survey, Data, and Stylized Facts* 40 (Int'l Monetary Fund Working Paper WP/12/203, 2012), <https://www.imf.org/external/pubs/ft/wp/2012/wp12203.pdf>.

86. *Id.* at 40, 62.

87. See Mitu Gulati & George Triantis, *Contracts Without Law: Sovereign Versus Corporate Debt*, 75 U. CIN. L. REV. 977, 990–97 (2007).

88. See IMF, *Guidance Note for Surveillance Under Article IV Consultation* 8–9 (May 2015), <http://www.imf.org/external/np/pp/eng/2015/031915.pdf>.

economic factors that affect financial stability.⁸⁹ The second program is the IMF's Special Data Dissemination Program. Member countries that voluntarily subscribe to this program commit to providing economic and financial data to the IMF for public dissemination on a regular basis.⁹⁰ If a member stops sending data or if the IMF is concerned about the information's veracity, the member becomes subject to escalating censures. Early censures are not made public, but the IMF eventually announces a country's continued refusal to cooperate.⁹¹

In addition to bilateral surveillance, the IMF intensively monitors and reports on countries under IMF reform and adjustment programs. Countries that borrow under certain IMF instruments must agree to intensive monitoring and reporting. Low-income countries may also choose to be intensively monitored and reported on without borrowing.⁹² A stated purpose of the IMF's discretionary monitoring programs is to enable countries to signal commitment to stabilizing economic policies.⁹³ Some sovereign debt contracts have required the borrower to remain a member in good standing of the IMF,⁹⁴ and in some cases countries have borrowed small amounts from the IMF specifically to show prospective creditors that they were willingly subjecting themselves to heightened IMF monitoring.⁹⁵

89. *Id.* at 9.

90. See IMF Standards for Data Dissemination, INT'L MONETARY FUND (Mar. 8, 2018), <https://www.imf.org/en/About/Factsheets/Sheets/2016/07/27/15/45/Standards-for-Data-Dissemination>.

91. Interview with IMF Staffer (July 18, 2017).

92. The IMF's Policy Support instrument (PSI) and Staff-Monitored Programs allow intensive monitoring without borrowing. See *Policy Support Instrument (PSI)*, INT'L MONETARY FUND (Mar. 8, 2018), <http://www.imf.org/en/About/Factsheets/Sheets/2016/08/02/21/21/Policy-Support-Instrument>; Interview with IMF Staffer (July 18, 2017).

93. See *Policy Support Instrument (PSI)*, *supra* note 92. Staff-Monitored Programs are informal agreements between the country and the IMF to monitor execution of a predetermined economic reform program. See *IMF Management Completes the Second Review Under the Staff-Monitored Program for Somalia and IMF Managing Director Approves a New Staff-Monitored Program*, INT'L MONETARY FUND n.1 (July 12, 2017), <https://imf-fmi.africa-newsroom.com/press/imf-management-completes-the-second-review-under-the-staffmonitored-program-for-somalia-and-imf-managing-director-approves-a-new-staffmonitored-program?lang=en>; Interview with IMF Staffer (July 18, 2017).

94. Gulati & Triantis, *supra* note 87, at 998.

95. *Id.* at 999.

When countries subject to intensive monitoring have defaulted, or are known to be at risk of default, the IMF's published reports might assess the sovereign's economic management, its resources available to pay creditors, and whether restructuring negotiations are following conventional best practices. Such IMF reports provide reasoned opinions about the causes of default or threatened default and details about the timing and terms of any restructuring offers and creditors' responses.⁹⁶ While publication of surveillance reports of a member country is subject to its consent, there is a presumption of publication under all monitoring programs except bilateral surveillance. Under bilateral surveillance, the IMF publishes a press release upon completion of each report. Therefore, under all of the IMF's monitoring programs, non-publication sends a negative signal.⁹⁷ IMF monitoring will thus provide at least some information relevant to assessing the causes of default and ability and willingness to pay.

However, market participants and observers have questioned for some time the IMF's capacity to serve as a delegated market monitor.⁹⁸ Moreover, creditors have reasons to anticipate that their perspectives on a debtor state's future behavior might differ from the views of the multilateral institutions, or that the multilateral institutions might, themselves, have reputational weaknesses that

96. See, e.g., IMF, Country Report No. 04/286, *supra* note 51.

The authorities have followed best practices in implementing the debt restructuring exercise (i.e., transparency, creditor consultations, and inter-creditor equity). They approached creditors at an early stage, while continuing to service fully their obligations under the program

. . . .

The debt restructuring process is lagging behind. The authorities announced a debt exchange offer on April 6, which includes a menu of three bonds, with long maturities, low interest rates and (two of them) at a discount. There has been partial creditor participation in the debt exchange offer and its deadline was extended twice. The larger domestic creditors (the National Bank of Dominica and the Social Security) and one of the two large bond issues have agreed in principle to participate. Discussions with the other private external creditors are continuing. Discussions with bilateral creditors are at an advanced stage, some of them have expressed a preference for waiting until the private debt deal is completed. The Caribbean Development Bank has agreed "in principle" to a debt restructuring proposal consistent with inter-creditor equity.

Id. at 5, 11 (emphasis omitted).

97. Interview with IMF Staffer (July 18, 2017).

98. See Gulati & Triantis, *supra* note 87, at 996–97.

limit their ability to credibly influence third parties. As explained by one market participant who has worked exclusively on emerging market sovereign debt since its origin in the 1990s, private-sector creditors have limited trust in the IMF. They see the IMF and private-sector creditors as having fundamentally conflicting interests when both are lenders to the same country,⁹⁹ and they see themselves as being in contest with public-sector lenders and at an informational disadvantage relative to them:

It's not a level playing field. The debt sustainability analysis does not make public all of the assumptions the IMF has, so the private sector is playing a guessing game to figure things out. The IMF has more information than the private sector, but they're not giving it out. The private sector says, give us all the tools you're using and let us do our own analysis, so we can be on the same level playing field as you. There is a tension when the determination is made about whether the country is holding all it can or is not doing all it can . . . It's not a search for the truth if one party is holding more of the cards.¹⁰⁰

One example of a disagreement between the IMF's assessment of ability to pay and that of creditors is the Iraq debt restructuring during the early 2000s. Some creditors believed that the IMF's debt sustainability analysis underestimated Iraq's expected oil income.¹⁰¹

Moreover, the IMF and other multilateral financial institutions are political institutions. They have multiple objectives that are not always aligned with the interests of particular creditors or creditors' rights in principle. They are often portrayed as having political stakes in particular outcomes.¹⁰² The positions the

99. See Panizza et al., *supra* note 1, at 671–72.

100. Interview with Senior Market Participant I (July 18, 2017).

101. Joanna Chung & Stephen Fidler, *Why Iraqi Debt Is No Longer a Write-Off*, FIN. TIMES (July 16, 2006), <https://www.ft.com/content/b94bccb4-14e7-11db-b391-0000779e2340>. Creditors in that case were restrained from litigating because of the heavy involvement of the official sector in support of Iraq.

102. See, e.g., Larry Elliott, *IMF's Own Watchdog Criticises Its Handling of Eurozone Crisis*, GUARDIAN (July 28, 2016), <https://www.theguardian.com/business/2016/jul/28/imf-watchdog-criticises-handling-eurozone-crisis>; Martin Sandbu, *Beware Greeks Bearing Rifts: Why Varoufakis Couldn't Fix the Debt Crisis*, FOREIGN AFF. (Jan./Feb. 2018), <https://www.foreignaffairs.com/reviews/review-essay/2017-12-12/beware-greeks-bearing-rifts>; Heather Stewart, *IMF Will Refuse to Join Greek Bailout Until Debt Relief Demands Are Met*, GUARDIAN (July 30, 2015), <https://www.theguardian.com/business/2015/jul/30/imf-will-refuse-join-greek-bailout-until-debt-relief-demands-met>.

multilateral institutions take in sovereign debt disputes are not based on transparent, predefined, universal, objective criteria, and are not always justified by publicly reasoned decisions.

Ecuador's default in 2008 illustrates the various reasons for creditors' limited trust of multilateral lending institutions. Ecuador's President Correa staged an "audit" of the country's foreign-issued debt, which concluded that the country's foreign debt was illegitimate and illegal on grounds ranging from legally incorrect and logically unsound to plausible.¹⁰³ The report scathingly criticized both Ecuador's private-sector and public-sector creditors, and concluded that loans from both involved irregularities.¹⁰⁴ Nonetheless, when Ecuador selectively and opportunistically defaulted on several of its bonds in 2008, it announced that it would not default on the \$4.3 billion it owed to the multilateral lending institutions.¹⁰⁵ Ecuador admittedly had no fiscal need to default, and its coercive restructuring flouted practices of transparency and good-faith negotiating promoted by the multilateral lending institutions. Yet, to creditors' consternation, no multilateral institution criticized Ecuador's imposition on creditors of a sixty-five percent haircut.¹⁰⁶ Officials of the Inter-American Development Bank (IADB) backed Ecuador.¹⁰⁷ Reuters reported that analysts said the Bank's backing "could strengthen Ecuador's position against bondholders by giving some legitimacy to the default and signaling that the tiny country holds the upper hand in negotiations"¹⁰⁸ One market analyst likened the

103. The audit was conducted by political appointees and not conducted with the counsel or participation of professional auditors according to accounting standards. See Porzecanski, *supra* note 56, at 270.

104. *Id.*

105. See Lee C. Buchheit & G. Mitu Gulati, *The Coroner's Inquest*, 28 INT'L FIN. L. REV., Sept. 2009, at 22; *Most Holders of "Illegal" Debt Settle with Ecuador*, LATINLAWYER ONLINE (June 12, 2009), https://files.skadden.com/sites%2Fdefault%2Ffiles%2Fpublications%2FPublications1891_0.pdf.

106. See Felix Salmon, *Lessons from Ecuador's Bond Default*, REUTERS: FELIX SALMON (May 29, 2009), <http://blogs.reuters.com/felix-salmon/2009/05/29/lessons-from-ecuadors-bond-default/> (describing creditors' frustrations with the default and the multilateral lending institutions' stance on it); Buchheit & Gulati, *supra* note 105, at 22.

107. See Porzecanski, *supra* note 56, at 268.

108. Alexandria Valencia & Alonso Soto, *Regional Lenders Back Ecuador in Debt Talks*, REUTERS (May 18, 2009), <https://www.reuters.com/article/us-ecuador-caf-loans-idUSTRE54H58220090518>.

IADB's support to "saying that Ecuador has a very strong hand against bondholders in a poker game," which "could prompt more investors to participate (in the buyback) to avoid being on the losing side."¹⁰⁹ An IMF official stated, "We understand that Ecuador's decision to default on these bonds is based on a dispute about [their] legal validity rather than [on] debt sustainability [grounds], and of course we don't take sides on the merits."¹¹⁰

The stance taken by the multilateral institutions on Ecuador's default was not decided through a transparent process based on rules known in advance. To the contrary, the support of Ecuador was inconsistent with customary market norms previously affirmed by the institutions about acceptable reasons for defaulting and how restructuring should be carried out. Moreover, the multilateral lending institutions had an apparent conflict of interest between their dual roles as lenders and market monitors. Ecuador levied many of the same allegations of legal violations and illegitimacy against their loans as it did against its private-sector debt but offered to stand down from repudiating public-sector debt and to force private-sector creditors to take the fall. It is not difficult to see, therefore, why market participants lack confidence in the multilateral institutions as reputation intermediaries.

2. Credit rating agencies

Credit rating agencies (CRAs) provide standardized reputational signals, combining various dimensions of sovereign borrower risk—including economic, political, and institutional factors¹¹¹—into a single credit rating. Ratings are forward-looking assessments of creditworthiness, measured either as the risk of default or the expected loss through default.¹¹² For sovereigns,

109. *Id.*

110. *Transcript of Regular Press Briefing by Caroline Atkinson, Director, External Relations Department, INT'L MONETARY FUND* (Dec. 18, 2008), <http://www.imf.org/external/np/tr/2008/tr121808.htm>, quoted in Porzecanski, *supra* note 56, at 269.

111. See Standard & Poor's Ratings Servs., *How We Rate Sovereigns* (Feb. 13, 2015), <https://www.spratings.com/documents/20184/774196/How+We+Rate+Sovereigns.pdf/a9419c9e-eb76-4283-83a6-34d0e8b13112>.

112. S&P's ratings only seek to capture the risk of default occurring, whereas Moody's tries to capture expected loss, a broader measure, and Fitch employs a hybrid that focuses only on default probability until default occurs, at which time it distinguishes based on

unlike corporations, they include an assessment of the risk of opportunistic default.¹¹³ Rating agencies maintain ratings continuously, reassess them periodically, and affirm or change them upon the occurrence of significant events that might impact creditworthiness. Agencies publish not only the alphanumeric rating category but also reasons for changing a rating or reports about particular issuers.¹¹⁴

Default is reflected in ratings in two ways. S&P's approach is illustrative. First, a sovereign's rating is immediately adjusted to D (Default) or SD (Selective Default) and remains in that category as long as it is in default.¹¹⁵ Agencies make their own determination of whether an action by the government is a default and do not rely on legal definitions of default.¹¹⁶ Default might include nonpayment or delayed payment of principal or interest, or any contract modification that reduces the value of bonds in a manner

expected recovery rates after default occurs. Ashok Vir Bhatia, *Sovereign Credit Ratings Methodology: An Evaluation* 4–5 (Int'l Monetary Fund Working Paper WP/02/170, 2002).

113. See NORBERT GAILLARD, *A CENTURY OF SOVEREIGN RATINGS* 13 (2012); S&P Glob. Ratings, *General Criteria: Principles of Credit Ratings* 6 (Feb. 16, 2011), https://www.standardandpoors.com/en_US/delegate/getPDF;jsessionid=9B0556F3C518FE65F2041644D9DED007?articleId=2017767&type=COMMENTS&subType=REGULATORY.

114. See, e.g., *Fitch Upgrades Argentina's Foreign Currency IDR to 'B'; Outlook Stable*, BUS. WIRE (May 10, 2016, 11:14 AM), <https://www.businesswire.com/news/home/20160510006412/en/Fitch-Upgrades-Argentinas-Foreign-Currency-IDR-Outlook>; Press Release, Moody's Investors Service, *Rating Action: Moody's Upgrades Argentina's Issuer Rating to B3 with a Stable Outlook* (Apr. 15, 2016), https://www.moody.com/research/Moodys-upgrades-Argentinas-issuer-rating-to-B3-with-a-stable-PR_347279; Press Release, S&P Glob. Mkt. Intelligence, *S&P Affirms Argentina Ratings* (Apr. 15, 2016) (affirming a B- debt rating).

115. See, e.g., S&P Glob. Ratings, *Research Update: Ukraine Foreign Currency Ratings Lowered To 'SD' (Selective Default) on Distressed Debt Restructuring* (Sept. 25, 2015), https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/20014208 (reporting change to Ukraine's rating prompted by its seeking to restructure its debt; rating adjustment announced three days after the government's announcement). Moody's does not use a "default" category but considers "Track Record of Default" as a factor that is used to adjust the score for "Institutional Strength," one of four factors that go to a sovereign's credit rating. See GAILLARD, *supra* note 113, at 26–27; Moody's Inv'rs Serv., *Rating Methodology: Sovereign Bond Ratings* 3 (Dec. 22, 2016).

116. See Bhatia, *supra* note 112, at 9; S&P Glob. Ratings, *Research Update: Ukraine*, *supra* note 115 (determining that Ukraine's invitation to bondholders to buy back debt is a "distressed debt restructuring"). See generally S&P Glob. Ratings, *General Criteria: Rating Implications of Exchange Offers and Similar Restructurings, Update* (May 12, 2009), <https://www.taiwanratings.com/portal/front/showCustomArticle/2c9c31d755d00f860156253779ee0074> (defining the criteria for determining when an exchange offering constitutes a distressed debt restructuring).

the agency deems to be “coercive, involuntary, and distressed.”¹¹⁷ Even a voluntary bond exchange might be classified as a default if the agency determines that creditors restructured because they expected that nonparticipation would leave them worse off.¹¹⁸

Once a sovereign has cured a default, its rating is adjusted to reflect the agency’s assessment of the state’s default risk at that time. The past default is taken into account because of its impact on other economic circumstances that go into the rating, as well as in the consideration of the country’s “debt payment culture.” Debt repayment culture is a “potential adjustment factor” that can reduce the sovereign’s scaled score in the Institutional Assessment, one of the five assessments that go into the rating. A sovereign determined to have a weak debt payment culture always receives an Institutional Assessment score of six, the lowest possible score. The Institutional Assessment score in turn caps the sovereign’s rating at BB+, which is speculative grade.¹¹⁹

Sovereign ratings by CRAs are decided by the ratings committee, in which a group of analysts pore over economic data and debate qualitative factors to process scores on input criteria, and other considerations, into ratings.¹²⁰ After debate, a nominated subset of the group votes on scores for various categories and, ultimately, on the final ranking.¹²¹

The ability of CRAs to offer investors assurance that they will serve as effective reputation intermediaries is compromised by the CRAs’ own reputation problems and the information risk that they face. Sovereign ratings have been criticized as political,¹²² incompetent,¹²³ and conflicted,¹²⁴ not least because sovereigns pay

117. See GAILLARD, *supra* note 113, at 13; Bhatia, *supra* note 112, at 9.

118. Bhatia, *supra* note 112, at 10.

119. S&P Glob. Ratings, *Sovereign Rating Methodology* 41–42 (Dec. 23, 2014).

120. Bhatia, *supra* note 112, at 10.

121. *Id.* at 12, 26.

122. Paul Krugman, *The Plot Against France*, N.Y. TIMES (Nov. 10, 2013), <https://www.nytimes.com/2013/11/11/opinion/krugman-the-plot-against-france.html>; Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 662 (1999).

123. *Bathurst Reg'l Council v Local Gov't Fin Servs Pty Ltd* [No. 5] (2012) FCA 1200, ¶53 (Federal Court) (Austl.).

124. BARTHOLOMEW PAUDYN, CREDIT RATINGS AND SOVEREIGN DEBT: THE POLITICAL ECONOMY OF CREDITWORTHINESS THROUGH RISK AND UNCERTAINTY 1 (2014); Bhatia, *supra* note 112, at 32–50.

to be rated.¹²⁵ Frank Partnoy has thoroughly described the limited informational value and reputational deficiencies of credit ratings.¹²⁶ While the divergence between market opinion and credit raters' opinions became more apparent during the Euro crisis, the gap between credit ratings and what investors care about was not new.¹²⁷

Rating agencies are also subject to information risks. Sovereigns have information-sharing agreements with CRAs, from whom they solicit ratings that require the sovereign to grant access to relevant information and personnel.¹²⁸ CRAs collect most of their data directly from sovereigns. While they try to triangulate with other sources, the quality of their ratings is heavily influenced by the quality of the country's data and the extent of its cooperation.¹²⁹ A sovereign in trouble can hide relevant information in ways that are difficult for an agency to detect.¹³⁰ A study of sovereign ratings concluded that "[t]he first and most basic problem confronting the ratings agencies is information risk"; "[s]overeign ratings analysts have limited ability to corroborate official data"; "ratings [are] often assigned or maintained in the absence of full information" because

125. Elaine Moore, *Do Sovereign Credit Ratings Still Matter?* FIN. TIMES (July 14, 2016), <https://www.ft.com/content/fa563ac4-492e-11e6-8d68-72e9211e86ab>; Jeannette Neumann, *SEC Charges Egan-Jones, Says Firm Exaggerated Its Expertise*, WALL STREET J. (Apr. 24, 2012, 7:28 PM), <https://www.wsj.com/articles/SB10001424052702303592404577364132973207216>.

126. See, e.g., Frank Partnoy, *What's (Still) Wrong with Credit Ratings*, 92 WASH. L. REV. 1407 (2017); Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, in FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59 (Yasuyuki Fuchita & Robert E. Litan eds., 2006); Partnoy, *supra* note 122.

127. The head of Fitch's sovereign ratings acknowledged, "What we look at and what investors look at is not always the same thing." Moore, *supra* note 125. When the modern emerging market bond market began to develop, ratings of emerging market sovereigns were untested and rating agencies already had credibility deficits from their ratings of other types of debt. Bhatia, *supra* note 112, at 42 (using statistical analysis of defaults and ratings to find consistent upside bias), 43–45 (discussing information risk, analytical constraints, and revenue bias). An early failure in sovereign ratings occurred during the 1997–98 Asian crisis, when emerging market ratings and the emerging market bond market were relatively new. *Id.* at 6; Emerging Mkt. Traders Ass'n, *History and Development*, EMTA, <http://www.emta.org/template.aspx?id=34> (last visited Oct. 10, 2018).

128. Rating agencies have access to government information and officials when ratings are solicited. Their analysts meet with officials from the "treasury or finance ministry, central bank, and other ministries responsible for areas of key economic importance . . . , politicians within and outside government." They also speak with official and private-sector observers within and outside the country. S&P Glob. Rankings, *Sovereign Rating Methodology*, *supra* note 119, at 41–42.

129. Bhatia, *supra* note 112, at 43.

130. *Id.* at 42.

of limited cooperation by governments; and “data shortcomings or willful concealment generally” are biased to the benefit of the sovereign.¹³¹ CRAs also have limited analytic capacity because of resource constraints.¹³² This leads to a conservatism that reduces the accuracy of ratings since a substantial part of what CRAs do is aggregate opinions from the creditor and debtor sides of the market through a rather opaque process.¹³³

Finally, investors’ reliance on credit ratings varies depending on their investment strategies. While some passive investors rely heavily on credit ratings, other investors conduct their own, more sophisticated analyses to improve the forecasts of credit rating agencies.¹³⁴ Nondiscretionary holdings by financial institutions compose a large proportion of sovereign bond holdings. Such bonds are held as part of mandates that prescribe features of the combination of equities that investment managers’ portfolios must contain. For example, a fund manager might be mandated to mimic the performance of the Bloomberg Barclays Global Aggregate Index. She will then hold sovereign bonds as dictated by a passive sampling method that buys and sells securities to match those in the index. A percentage of the fund will comprise, for example, emerging market sovereign bonds of a certain rating. Alternatively, a manager might have a mandate to hold a certain share of bonds with a particular credit rating, or bonds that are investment grade. Under these investing approaches, some of which are regulation driven, a drop in a sovereign’s credit rating below a certain level will automatically prompt a sale.¹³⁵ Discretionary investment, in contrast, tries to beat the market and relies less on credit ratings. Some discretionary investors attend more carefully to the legal

131. *Id.* at 43–44.

132. *Id.* at 45.

133. *See id.*; *see also* GAILLARD, *supra* note 113, at 14 (describing how S&P’s actual criteria differ from its published criteria: S&P states that its ratings reflect only default probability, but its ratings might also reflect expected severity of default).

134. Interview subjects confirmed this to be the case in sovereign debt investment. Interview with Senior Sovereign Debt Economist (July 6, 2017); Interview with Distressed Debt Researcher and Advisor (Mar. 2, 2014). Other scholars have found the same to be true of investors in other fixed income markets. *See* Jane Tripp Howe, *Credit Analysis for Corporate Bonds*, in *BOND CREDIT ANALYSIS: FRAMEWORK AND CASE STUDIES* 43 (Frank J. Fabozzi ed., 2001).

135. Interview with Investment Analyst (May 28, 2017).

terms in bonds; distressed debt investors scrutinize the legal terms closely.¹³⁶ But notice also that the ability of a drop in a sovereign's credit rating to automatically trigger bond sales and to exclude its debt from many large portfolios increases the reputational leverage a holdout creditor can have by lengthening the time in default or showing a creditor to be unwilling, rather than unable, to pay.

III. WHY COURTS?

As discussed above, scholars usually think of formal legal enforcement through courts as an alternative to informal enforcement. In the literature discussing opting out of the legal system, parties eschew courts because courts do not cost-effectively provide incentives that reduce the risk of contract failure to an acceptable level, given the value of trade at stake. In those cases, courts have one or more of several weaknesses. They are corrupt or incompetent; they apply rules, interpretive methods, or remedies unsuited to the trade; or resorting to litigation undermines an ongoing commercial relationship that the parties wish to sustain. Traders therefore develop alternatives to expand the domain of value-creating exchange.¹³⁷ Why, in the sovereign bond context, do courts emerge as the lowest-cost provider of certain types of important information? Why do actors in this market, which by most accounts runs on informal enforcement, resort to courts?

The sovereign debt market's reliance on courts together with other sources of reputation information is, to some extent, a "belt and braces" approach to reputation verification. The previous Part outlined the weaknesses of other sources of information. Just as sovereigns solicit ratings from multiple credit rating agencies and investors triangulate among multiple agencies' ratings, it is not

136. Interview with Senior Sovereign Debt Litigators (July 29, 2017); Interview with Senior Sovereign Debt Economist (July 6, 2017); Interview with Investment Analyst (May 28, 2017).

137. Bernstein's diamond merchants, for instance, resorted to informal governance in part because courts could not offer remedies that would reliably and adequately compensate merchants for contract breaches. Bernstein, *Opting Out*, *supra* note 11. Similarly, the legal system would not support the relations of Greif's Maghribi traders because the promises they exchanged were not of an enforceable type, because courts could not verify their actions, and because courts could not reach traders in distant locales or their assets to exercise enforcement authority. *See Greif, supra* note 50.

surprising that, in a high-stakes market governed largely by reputation, actors choose to also make courts available as an alternative adjudicator of reputation.¹³⁸

But courts also provide information that other providers cannot or will not provide. Through litigation, holdout creditors can reveal information that other reputation-shaping institutions do not provide and that matters to investors and other third parties with sanctioning power. One distressed debt investor who has sued a defaulting sovereign put it thus: “We’re the only ones who have the financial means, motivation and sophistication to unravel incredibly sophisticated schemes.”¹³⁹ A baseline requirement for courts to function in this capacity is that the value at stake in sovereign debt disputes warrants resort to litigation. Unlike many other markets in which contractual obligations are enforced primarily by reputation, monitoring costs and sums at stake in the sovereign debt market are often sufficiently high to justify recourse to costly litigation.

If this condition is satisfied, courts can perform three distinctive information functions in sovereign debt disputes. First, unlike other reputational institutions, they can make legal determinations that coordinate and uphold market participants’ expectations. Second, courts have unique information-forcing and processing powers. Third, creditors use litigation to reframe the political and moral aspects of sovereign debt disputes.

A. Legal Determinations Matter

Actors in the sovereign debt market accept the decisions of the courts that decide sovereign debt disputes as authoritative on whether certain behavior at the local level—that is, between particular parties—constitutes breach.¹⁴⁰ By choosing New York law and submitting in its bond indenture to litigation in New York, a sovereign commits to having its treatment of individual

138. Cf. Laurence R. Helfer & Anne-Marie Slaughter, *Why States Create International Tribunals: A Response to Professors Posner and Yoo*, 93 CAL. L. REV. 899, 931–36 (discussing the literature on how states create international tribunals to enhance the reputational impact of violations of international law).

139. Aram Roston, *Vulture Capitalism*, PLAYBOY, Dec. 2010, at 60, 185 (quoting a distressed debt investor).

140. Hadfield & Weingast, *supra* note 20, at 10.

creditors judged against its contractual obligations and a body of law that instantiates commercial norms widely accepted by the market in a public forum trusted by creditors. New York law and courts take a formalistic, predictable approach to adjudicating business disputes. These features of judicial decision-making contrast sharply with the decision-making processes of the other information intermediaries operating in this market, described above.¹⁴¹ First, courts attend to the complaints of individual creditors. Since courts uniquely apply *legal* rules and *legal* reasoning through a *legal* process, they assure transacting parties of some measure of stability of norms and their application. By doing so, they support planning and investment. This function of courts is fundamentally different from the reputational function served by CRAs and multilateral financial institutions.

This function of law and courts in sovereign debt disputes is a paradigmatic example of a legal order without centralized enforcement as theorized by Hadfield and Weingast. Parties to sovereign debt contracts choose New York or UK law as the rules that govern their contractual relationships. As Hadfield and Weingast explain, those rules assign behavior to the classification of “breaching” or “nonbreaching.” Parties choose the courts of those jurisdictions to authoritatively apply the chosen classification rules.¹⁴² Hadfield and Weingast find an equilibrium in a repeated game in which a third-party institution providing such a “common logic” sustains collective enforcement. Their equilibrium requires the coordinating institution to operate according to classic attributes of law, including “generality,” “stability,” “qualified universality,” “clarity, noncontradiction,” and “impersonal, neutral, and independent reasoning.”¹⁴³ These are defining features of courts.

141. See *supra* Section II.D.

142. See Hadfield & Weingast, *supra* note 20, at 7–8.

143. *Id.* at 3–9. I depart from Hadfield and Weingast’s requirement of punishment. Their model involves what is known as “altruistic punishment” because parties that respond to negative reputational signals by declining to transact do not do so out of immediate self-interest. As explained above, I build on Tomz’s theory of the sovereign debt market, which rests not on altruistic punishment but on self-interested responses to heightened risk. See *supra* notes 57–68 and associated text. Hadfield and Weingast’s model nonetheless applies because they separate the adjudicator’s information-production role from its remedial role and show that the former can support a legal order.

Completely private ordering requires a shared understanding of what behaviors constitute violations of norms that warrant sending negative reputation signals to the market.¹⁴⁴ The complexity of sovereign debt contracting renders it impossible for private coordination to categorize all relevant behaviors. Adjudication therefore substitutes for this aspect of private order. As explained above, other things being equal, investors consider a sovereign that treats creditors poorly during default worse than one that restructures in a way that creditors perceive as fair.¹⁴⁵ Default activates a number of other contract terms such as collective action clauses and other provisions envisaged to enable restructuring. A sovereign is subject to additional reputational penalties for failing to renegotiate and conduct its default in accordance with the terms of the bond and in good faith.

In hard cases—those in which the behavior of the parties is difficult to categorize under their respective legal rights and obligations—courts determine the content of sovereign promises and verify adherence to, or breach of, those promises rather than leaving those determinations to a contest of allegations. They therefore protect not only creditor expectations but also sovereign expectations and reputation against opportunistic creditors. In that sense, courts attend to reputation on a micro level, examining the bilateral relationship. They judge treatment of particular creditors and empower those creditors to demand that the state's treatment of them be publicly judged against legal rules that embody market expectations for contractual counterparties. CRAs and the IMF, by contrast, focus on sovereign behavior at a macro level.

144. See MacLeod, *supra* note 20. One way that parties address situations in which contractual performance is poorly correlated with outcomes is through warranties. Under a warranty, the performing party can prevent the dissatisfied counterparty from sending a negative reputation signal to the market by paying compensation or remediating the unsatisfactory outcome. See *id.* However, warranties such as those that promise to remedy product defects are unsuitable to bonds because a bond failure—a default—will affect a high proportion of bonds at once and *ipso facto* involves a (real or claimed) inability to pay amounts owed. This latter feature necessarily implies an inability to make a warranty payment sufficient to make creditors whole. See JONATHAN MACEY, THE DEATH OF CORPORATE REPUTATION 17–20 (2013). In close-knit communities, other sources of norm coordination exist, such as shared religion or ethnicity. See Bernstein, *Opting Out*, *supra* note 11; Greif, *supra* note 50; Landa, *supra* note 50.

145. See *supra* note 80 and accompanying text.

The obligation to repay under sovereign debt contracts is usually sufficiently simple that a minimally informed observer can see that a default has occurred. Sovereign debt contracts require repayment of specified sums on specified dates. Credit rating agencies and trade associations declare default within days of nonpayment. Courts routinely decide on summary judgment that default has occurred. When other legal issues presented require a full hearing, the analysis of whether default occurred is straightforward and brief.¹⁴⁶ However, other rights and obligations of the parties to sovereign bond contracts are complex. The contract might contain collective action clauses, exit consents, amendment clauses, acceleration clauses, cross-default clauses, or aggregation clauses that require interpretation and application to facts to determine whether a promisor has run afoul of its obligations. The governing law supplies additional rights and obligations. The rights and obligations specified in the contract and the governing law can powerfully impact restructuring negotiations. Courts have the capacity and credibility to resolve disputes concerning these terms in ways that market participants will accept. Even without formal enforcement, the courts' pronouncements establish authoritative decisions on parties' competing claims.¹⁴⁷

Elliott Associates v. Peru offers an illuminating example of this function of courts and a related hypothetical.¹⁴⁸ Peru argued that Elliott was not a valid assignee for various reasons, including that its purchase of debt on the secondary market violated New York's champerty law.¹⁴⁹ It was not obvious how New York's champerty law, which was a century old, applied to the new investment

146. See, e.g., *Elliott Assocs. v. Republic of Peru*, 12 F. Supp. 2d 328, 344 (S.D.N.Y. 1998) ("Failure to tender payment pursuant to a contract is a material breach. Therefore, where a contract unambiguously requires the defendant to make payments pursuant to its terms, and the defendant fails to make said payments, judgment must issue in favor of the plaintiff. These principles are routinely applied in favor of creditors suing foreign states on defaulted loan agreements." (citations omitted)).

147. See Hadfield & Weingast, *supra* note 20. Interview with Senior Sovereign Debt Lawyer VI (Aug. 22, 2017) ("The mere fact of a judgment or arbitral award has force, there is no doubt about that. . . . The judgment then resolves the issue that there's no dispute to be had whether the money's due. The judgment or award has a legal consequence or moral effect.").

148. *Elliott Assocs.*, 12 F. Supp. 2d at 328 (reversed by *Elliott Assocs. v. Banco de la Nacion*, 194 F.3d 363 (2d Cir. 1999)).

149. *Id.* at 344.

strategy of distressed sovereign debt investors. The practice was controversial, even among investors, because distressed debt investors frustrated other creditors' efforts to restructure their debt holdings by buying debt on the verge of restructuring and refusing to participate.¹⁵⁰ The district court discussed the commercial policy implications of barring the practices of the distressed debt investors by applying champerty law:

Elliott's position is strong as a matter of policy in the world of commerce. Peru borrowed billions of dollars from commercial banks in exchange for the obligation to repay the principal with interest. Peru spent the borrowed funds, and now refuses to repay an assignee of the debt. Failure to enforce a bargain between sophisticated parties such as Peru and their lenders would, according to Elliott, undermine reasonable expectations about contract law, the *terra firma* upon which contemporary business transactions are based. Moreover, restrictions on the rights of commercial lenders to assign the debt were not negotiated for by Peru, and imposing some restriction here seems at odds with the strong policy in favor of the free alienability of property. Cast in this light, § 489[, the champerty statute,] seems to fit uncomfortably with current sensibilities—a relic of Medieval English legal concerns about the perversion of judicial process given effect by the common law doctrine of champerty.¹⁵¹

After concluding the discussion with the counterpoint, "Yet, the Court's role here is not to make policy assessments[,]"¹⁵² the court held that the creditor's actions violated the state's champerty law.

The Second Circuit overturned the ruling, determining that the creditor's conduct did not constitute champerty.¹⁵³ It supported its holding with both legal and commercial policy reasoning. The commercial policy analysis was that applying champerty law to disallow assignment of distressed debt would render restructurings effectively involuntary and force creditors to "participate in an involuntary 'cram-down' procedure."¹⁵⁴

Had the Second Circuit upheld Peru's victory on the issue in the district court, and if Elliott were the only remaining holdout, Peru

150. See *id.* at 335–36.

151. *Id.* at 345.

152. *Id.*

153. Elliott Assocs. v. Banco de la Nacion, 194 F.3d 363, 367 (2d Cir. 1999).

154. *Id.* at 380.

would have had no legal obligation to pay Elliott, and Elliott would have lost any power to prevent Peru from curing its default in the eyes of the market. That outcome would have reduced Peru's time in default and therefore the harm to its reputation. Future bond purchasers might have demanded a higher yield from emerging market sovereign bonds given the reduced liquidity revealed or created by the court's decision, but there would be no reason for them to see Peru as posing any special risk because it had successfully asserted its legal rights.

B. Gathering and Processing Facts

Creditors use courts to reveal two types of factual information relevant to sovereign debtor reputation. The first type is relevant to reputation for promise keeping and law adherence. To apply the relevant rules to the instant case, a court must, of course, ascertain the relevant facts. During a contentious dispute, courts have the institutional capacity to obtain and process factual information necessary to determine the parties' legal rights and obligations. In addition, courts play a second informational role in this market. They allow creditors to obtain information that is not directly relevant to whether breach occurred, but that goes to the state's ability to pay. This information is relevant, for different reasons, to third parties who have power to punish the government officials responsible for the decision not to pay the creditors.

1. Facts that determine legal rights and obligations

Courts ascertain facts about the behavior of debtors and creditors during default and restructuring processes. The adjudicated facts in turn determine the parties' legal rights and obligations, which, as explained above, matter to investors and other potential transactors with the sovereign.¹⁵⁵ For example, in the litigation between Elliott Management and Panama arising out of that state's restructuring of syndicated bank loans, an issue of law was whether Panama even owed any contractual obligation to Elliott. Panama argued that the assignments of the debt to Elliott were invalid because more than half of the lenders had activated

155. See *supra* Section III.A.

the original contract's amendment clause, thus barring assignment of the debt. Whether the assignments were valid hinged on a disputed factual issue: the date on which the assignments were made. In finding that the assignments were made before the deadline imposed by the restructuring agreement, the court assessed no fewer than eight independent sources of evidence in the record and highlighted undisputed facts that supported the court's conclusion as to the dates.¹⁵⁶

Two aspects of the court's institutional capacity permitted it to adjudicate the disputed facts: it was empowered to collect evidence through sworn testimony and document production and to authoritatively determine the truth of the matter. Absent the judicial power to compel the production of evidence and take testimony under oath, each party could hide evidence as to disputed facts and indefinitely maintain the truthfulness of its position, leading to a reputational impasse. Absent a credible third-party adjudicator to render a decision on these disputed issues of fact, reputation for promise keeping and law adherence could not be authenticated.¹⁵⁷ The state and the lenders that wanted to restructure could have colluded against the unpopular holdout.

While CRAs and multilateral financial institutions have significant access to information about sovereign debtors, courts have unique information production capacities. They allow the parties to demand the production of information of their choosing. Even if a court has little ability to sanction a sovereign for resisting judicial information-gathering power, defiance of a court is publicized and results in adverse reputational inferences. Stonewalling a court, or being found to have provided false or misleading documents or testimony, poses a greater risk to reputation than evading or misleading a CRA. That is not least because a CRA has incentives not to report being misled or

156. *Elliott Assocs. v. Republic of Pan.*, 975 F. Supp. 332, 337-38 (S.D.N.Y. 1997) (describing and assessing the evidence offered by both parties, which included sworn testimony by an executive of Elliott Associates as to the procedure by which the transaction was concluded and the relevant dates, "hand-written trade tickets and confirmatory documents," copies of letters from the original lenders to the courts in related proceedings in state court, "Assignment Notices" submitted to Panama by the original lenders and Elliott, and sworn testimony by an employee of one of the defendant banks as to the meaning of those "Assignment Notices").

157. Cf. Kishanthi Parella, *Reputational Regulation*, 67 DUKE L.J. 907, 923-24 (2018).

stonewalled, but also because its process lacks the public performance element of judicial process. Additionally, litigating creditors can compel information from third parties that courts can sanction. The New York or London forum selection clause thus operates as a reputation bond posted by creditors and sovereigns to back a commitment to honesty and forthrightness during the restructuring process.

2. Facts relevant to other dimensions of reputation

As discussed above, one way that creditors can increase reputational harm to sovereign debtors is by revealing information on multiple dimensions of reputation.¹⁵⁸ Third parties who have the power to sanction public officials might do so for reasons apart from the officials' decisions to breach duties owed to creditors. Creditors have pursued this strategy by using sovereign debt litigation to reveal corrupt activities by debtor state governments. They argue that the state is able to pay but that the government is unwilling to pay because political leaders are diverting public funds to themselves. Corruption revelations might hurt a country's bond market position with sovereign bond investors, who look at both economic fundamentals and political risk.¹⁵⁹ The market considers sovereigns that default opportunistically to be higher risk, all else equal.¹⁶⁰ Credit rating agencies' institutional assessments consider corruption.¹⁶¹ But corruption is more reliably harmful to reputation across social fields than is reputation for treatment of creditors. Whereas the domestic population might reward the government for reneging on foreign-issued debt, it is unlikely to view the misappropriation of public funds favorably. Similarly, while foreign countries and multilateral institutions that have relationships with the debtor and that provide aid, loans, and other economic benefits might side with a sovereign regarding

158. See *supra* Section IV.B.2.

159. Interview with Senior Sovereign Debt Economist (July 6, 2017) (identifying corruption as a key issue in the political assessment that goes into sovereign debt investment, advising: "[I]t's all about the economic fundamentals and the politics. We would hire political scientists.").

160. See *supra* notes 80–81 and accompanying text.

161. See S&P Glob. Rankings, *Sovereign Rating Methodology*, *supra* note 119, at 11–12.

payment of creditors, the revelation of corruption makes those actors less willing or able—for ethical, political, and reputational reasons—to maintain support for the debtor.

Domestic political constituencies, other states, and public multilateral lending institutions take a more reliably negative view of corruption than of failing to pay foreign creditors. Lengthy sovereign default disputes tend to involve countries with severe, systemic corruption.¹⁶² Leveraging that fact, creditors have, in several cases, pursued a strategy of using discovery to uncover corruption, thereby imposing the threat of ongoing reputational damage on ruling elites as long as litigation continues. These costs can help creditors through two mechanisms. In the first, government officials implicated in corruption are pressured to settle to prevent further discovery of their corrupt activities. In the second, the corruption revelations undermine the sitting government and open the door for a new government willing to settle with creditors. As two senior sovereign debt lawyers explained, “The strategy . . . is . . . to allow the political forces at play within the country to know that this is an obligation that needs to be dealt with. . . . You hope you might find some assets, but that’s not the primary reason [for suing].”¹⁶³ The lawyers explained that in one dispute they got the attention of politicians in powerful Western countries and elevated the dispute to an international relations issue by using litigation to uncover the corrupt activities of the government in power in the debtor state.¹⁶⁴

Two recent cases are illustrative. A holdout against the Republic of Congo leveraged discovery of corruption by the country’s autocratic president, his family, and other top officials to obtain a settlement of its debt claim. Through discovery, for example, creditors of the Republic of Congo uncovered shell companies used to misappropriate oil assets and showed that the president’s son had used funds from those companies for personal

162. See Roger Parloff, *Judge: Vulture Fund Leaked Documents to Human Rights Group*, FORTUNE (Aug. 21, 2007), <http://fortune.com/2007/08/21/judge-vulture-fund-leaked-documents-to-human-rights-group/>.

163. Interview with Senior Sovereign Debt Litigators (July 29, 2017).

164. *Id.*

purchases of luxury goods.¹⁶⁵ Creditors disclosed the incriminating documents to the anti-corruption organization Global Witness, which posted them to its website together with an analysis of the corruption they revealed. The creditors also released the documents to news outlets in several countries.¹⁶⁶ The information was widely reported and drew attention both within and outside the Republic of Congo.¹⁶⁷

The creditors obtained the documents through a Hong Kong court. After Global Witness, based in London, published the documents on its website, an offshore company owned by Denis Sassou-Nguesso, the son of the Congolese president, asked a UK court to order that they be taken down.¹⁶⁸ The UK court decided in Global Witness's favor, not only in permitting public disclosure of the documents but also in publishing a reasoned decision for his ruling, which compounded the reputational damage by publicizing efforts to hide the information. Sassou-Nguesso had asked the court to discharge the case confidentially, which would have prevented the publication of the court's decision and prevented Global Witness from speaking about the case. Sassou-Nguesso also asked the judge not to refer in his opinion to the litigation in Hong Kong because the courts there had kept the proceedings confidential. The court rejected all of the claimant's secrecy requests and disclosed them in the opinion, asserting a strong public interest in disclosure of the details of the litigation. He explained,

If I were not to refer to the order [of the Hong Kong court], I would in my view give to the public a misleading account of the relevant events and of the matters I have taken into account in reaching my conclusion. . . . If I were to refer to that order in a separate confidential judgment, I should preclude GW and others from referring to it. In the context of this case, . . . there is a significant public interest in the subject matter of GW's publications¹⁶⁹

The information revealed through the litigation catalyzed several chain reactions that put pressure on Congolese officials. The

165. See *Long Beach Ltd. v. Glob. Witness Ltd.* [2007] EWHC 1980 (QB), [9]–[15] (Eng.).

166. See *id.* at [40.7].

167. See *id.* at [42].

168. See *id.* at [18].

169. *Id.* at [28].

detailed corruption revelations were a political liability within Congo. An anti-corruption activist in the country told the *New York Times*, "If it were not for these vulture funds, we would not know any facts about the way our country's wealth is being taken away We don't agree with their ultimate aims, but they are the only ones capable of exposing the truth."¹⁷⁰ Revelations of corruption also prompted political action in donor countries. A Member of the UK Parliament sought information from the UK Secretary of State for International Development about what actions had been taken by the IMF, the European Union, and the UK government regarding corruption relating to Congo-Brazzaville's oil trade.¹⁷¹ The documents were brought before the U.S. House of Representatives by Representative Diane E. Watson, who described the corruption revealed by the documents at length, highlighted the poverty of the Congolese population, and suggested that Congo was in breach of its commitments under a multilateral debt relief program.¹⁷²

Donor countries have the power to block aid and lending to countries such as Congo. While the creditors were uncovering details about the misappropriation of Congolese oil revenues, Congo was negotiating for conditional aid from a joint program of the IMF and World Bank. The institutions agreed preliminarily to provide debt relief but required the country to reduce corruption before it would qualify for permanent debt relief. The revelation of new corrupt activities threatened the country's receipt of funds from the multilateral financial institutions.¹⁷³

The details revealed through the litigation about how officials structured oil transactions to misappropriate funds were valuable to Global Witness and enabled it to expand its own investigations. The organization knew that corruption was occurring in the oil

170. Lydia Polgreen, *Unlikely Ally Against Congo Graft*, N.Y. TIMES (Dec. 10, 2007), <http://www.nytimes.com/2007/12/10/world/africa/10congo.html>.

171. See *Long Beach Ltd.* [2007] EWHC 1980 (QB) at [42].

172. See 110 CONG. REC. E1500 (daily ed. July 11, 2007) (statement of Rep. Diane E. Watson) (referring to the Global Witness documents).

173. See John Cassidy, *The Next Crusade*, NEW YORKER (Apr. 9, 2007), <http://www.newyorker.com/magazine/2007/04/09/the-next-crusade>; Robert Friedman, *The Vulture Wars*, CNN MONEY (June 12, 2006, 10:03 AM), http://money.cnn.com/2006/06/09/news/international/congo_fortune/.

sector but lacked details about how it was carried out. The creditors were able to marshal the information-gathering resources of the courts that were not available to NGOs investigating corruption.¹⁷⁴ The litigation produced information about specifically which Congolese officials were involved, how they were spending their ill-gotten gains, and which foreign banks and law firms facilitated the transactions.¹⁷⁵

Moreover, the litigation uncovered activities that formed the basis for separate legal action against not only the state and its public officials but also parties with which it transacted. The creditors brought a RICO action in the United States against Congo, its state-owned oil company, and a French bank, alleging money laundering and other unlawful activities.¹⁷⁶ Third parties that transacted with Congo now risked being implicated in corruption and money laundering and becoming embroiled in related legal action.¹⁷⁷ French prosecutors, under pressure from transparency and anti-corruption NGOs, opened investigations into Congolese elites who held wealth in France.¹⁷⁸ Amid these developments, Congo settled with the creditor, reportedly paying \$90 million of the \$100 million in judgments it held.¹⁷⁹

One of Argentina's creditors pursued a similar strategy when prosecutors and investigative reporters in Argentina uncovered evidence of corruption by the Kirchners and a business associate of theirs, a scandal known in Argentina as "The Route of the K[irchner]-Money."¹⁸⁰ The creditor obtained discovery orders in

174. See Interview with Senior Anti-corruption Activist (July 18, 2017).

175. See *id.*

176. See *Kensington Int'l Ltd. v. Itoua*, 505 F.3d 147, 148, 152–53 (2d Cir. 2007).

177. See also Interview with Felix Salmon (July 28, 2017).

178. See Interview with Senior Anti-corruption Activist (July 18, 2017); Shirley Pouget, *Why a Trial in Paris Marks a Milestone for Anticorruption Activists*, OPEN SOC'Y FOUND. (June 16, 2017), <https://www.opensocietyfoundations.org/voices/why-trial-paris-marks-milestone-anticorruption-activists>.

179. Roston, *supra* note 139, at 183.

180. See *NML Capital Ltd. v. Republic of Arg.*, No. 2:14-cv-492-RFB-VCF, 2014 WL 3898021, at *2–4 (D. Nev. 2014); *Argentina's Ex-President Kirchner in Court over Another Corruption Case*, FRANCE 24 (Sept. 18, 2018), <https://www.france24.com/en/20180918-argentinas-ex-president-kirchner-court-over-another-corruption-case>; Santiago Pérez & Taos Turner, *In Argentina, Mix of Money and Politics Stirs Intrigue Around Kirchner*, WALL STREET J. (July 28, 2014), <https://www.wsj.com/articles/in-argentina-mix-of-money-and-politics-stirs-intrigue-around-kirchner-1406601002> (discussing the corruption scandal).

U.S. Federal Court in Nevada relating to straw companies set up by the Panamanian law firm Mossack & Fonseca of the infamous Panama Papers leaks. Those straw companies allegedly were used to embezzle \$65 million in public funds through corruptly obtained public works contracts.¹⁸¹ President Kirchner had sought to quash the investigation in Argentina by firing the prosecutor who originally reported his findings of corruption.¹⁸² The action in Nevada reinforced and exacerbated the corruption allegations and threatened to lead to further revelations. The leading Argentinian newspapers reported on the U.S. litigation, including the U.S. court's finding that the creditors had proven that public funds had been embezzled.¹⁸³

In Argentina's dispute with holdouts, the link between information revealed about corruption by the creditors' litigation efforts and the state's decision to settle is less clear than in the Congo case. That is because the *pari passu* ruling and the related injunctions placed such intense pressure on Argentina, and because President Kirchner's party no longer controlled the executive branch when the debt was settled. However, the case suggests how litigation might credibly threaten to unseat politicians, especially in democracies, who are susceptible to corruption allegations and unwilling to pay creditors.

C. Issue Framing by Litigants

Courts allow litigants to argue publicly over the relevant norms and how they apply to the parties' behavior. The other reputation-shaping institutions that operate in this market have internal, top-down agenda-setting processes and lack the public aspect of courts that allows them to perform this function. As described above, credit ratings seek to produce systematic deductions from a

181. See *NML Capital*, 2014 WL 3898021 at *2-5.

182. See *Prosecutor Campagnoli to Remain Suspended*, BUENOS AIRES HERALD (Dec. 24, 2013), <http://www.buenosairesherald.com/article/148187/prosecutor-campagnoli-to-remain-suspended>.

183. See *Un caso que comienza a afianzar las sospechas* [A Case that Begins to Reinforce Suspensions], LA NACION (Mar. 18, 2015), <http://www.lanacion.com.ar/1777054-un-caso-que-comienza-a-afianzar-las-sospechas>; Daniel Santoro, *Un juez de EE.UU., tras las empresas atribuidas a Báez* [A U.S. Judge, After the Companies Attributed to Baez], CLARIN (Aug. 13, 2014), <https://opisantacruz.com.ar/2014/08/13/un-juez-de-ee-uu-tras-las-empresas-atribuidas-a-baez/>.

compilation of various qualitative and quantitative data inputs. To produce ratings that allow comparison across the matrix of not only sovereign but all debt issuers,¹⁸⁴ CRAs follow defined methodologies that set out the factors and weights by which they assess sovereign creditworthiness. While CRAs, like courts, take in information from market participants, they run that information through their own rigid framework of relevant factors and weights. But CRAs are poorly placed to highlight new or idiosyncratic issues or to give the disputing parties a platform in which to do so. Similarly, the IMF has a mission much broader than the particular concerns of debt holders.

During litigation, by contrast, although the parties' arguments are somewhat constrained by the applicable legal rules, they have space to highlight issues they deem relevant or want to make salient, or to press changes to the law. Recourse to courts gives the parties a forum in which to shape the norms by which others should judge the parties' behavior. This dynamic of sovereign debt litigation accords with Michael Reisman's theory of international law as a process of communication¹⁸⁵ and Avner Greif's theory of how economic actors change "the rules of the game" over the long run by institutional development that supplies new information or changes payoffs.¹⁸⁶ Greif names courts and credit bureaus as two paradigmatic examples of such institutions.¹⁸⁷ In sovereign debt litigation, courts vie institutionally with other sources of information about sovereign creditworthiness and related behavior.¹⁸⁸

While the IMF deemphasizes corruption and CRAs consider it as but one among a host of relevant factors, creditors use the courts

184. See GAILLARD, *supra* note 113, at 16.

185. Cf. W. Michael Reisman, The Harold D. Lasswell Memorial Lecture, *International Lawmaking: A Process of Communication*, 75 AM. SOC'Y INT'L L. PROC. 101, 105-07 (1981) (discussing the theory of international lawmaking as a product of communications among groups, which "are, perforce, communications networks" in which participants contend to shape norms through various available channels).

186. See Avner Greif, *Cultural Beliefs and the Organization of Society: A Historical and Theoretical Reflection on Collectivist and Individualist Societies*, 102 J. POL. ECON. 912, 915-16 (1994).

187. *Id.*

188. Cf. PAUDYN, *supra* note 124, at 1-2 (discussing a contest between sovereigns and credit rating agencies to "constitute what counts as authoritative knowledge in the market").

to place it front and center.¹⁸⁹ This allows them to reframe the reputational dispute between themselves and the government of the sovereign debtor. Sovereigns frame litigation by holdout creditors as preying on the population of indebted countries.¹⁹⁰ By using litigation to uncover corruption, creditors have been able to offer a competing frame, arguing that it is not they but the government that is preying on the population, impoverishing the country by stealing public funds that could be used to repay creditors.¹⁹¹

In the Congo litigation,¹⁹² the court's analysis raised accountability issues, not only for the leaders of Congo but also for Western governments and multilateral financial institutions that had agreed to provide debt relief to the country. The court spoke directly to an issue that was the subject of heated controversy: whether development aid should be conditional on good government within recipient countries, and if so, to what extent. The United Kingdom had recently expressed strong opposition to the World Bank's efforts to withhold aid from countries known to have severe corruption problems. The United Kingdom had announced it would withhold funds from the Bank in response.¹⁹³ The UK court quoted at length from a World Bank document

189. See Interview with Senior Anti-corruption Activist (July 18, 2017) ("The IMF would say it's not their job to [assiduously investigate corruption]. But why are these countries getting debt relief when they are having huge revenues coming in that are just not properly managed[?]").

190. Interview with Senior Sovereign Debt Lawyer VI (Aug. 22, 2017) ("The country is getting poor, and some NY hedge fund is getting very rich.").

191. Interview with Senior Sovereign Debt Lawyers III and IV (July 29, 2017) ("It's the corrupt regimes that tend not to want to deal fairly with their creditors."). A journalist who has reported extensively on sovereign debt described how a creditor that had obtained discovery about corruption by the leaders of the Republic of Congo approached him about reporting that information and then was displeased that, in reporting it, the journalist highlighted that the creditor's purpose was to recover money. In the journalist's telling, the creditor wanted the emphasis placed on the government's bad actions and believed that highlighting the creditor's profit motive undermined the reputational hit of the information. See Interview with Felix Salmon (July 28, 2017).

192. See discussion *supra* notes 165–179 and accompanying text.

193. Heather Marquette, *The World Bank's Fight Against Corruption*, 8 BROWN J. WORLD AFF., Spring/Summer 2007, at 27, 28; Hilary Benn, *Full Text of Hilary Benn's Speech on Corruption*, GUARDIAN (Feb. 3, 2006), <https://www.theguardian.com/politics/2006/feb/03/development.internationalaidanddevelopment>; Francis Fukuyama, *A Battle Paul Wolfowitz Can't Win*, AM. INTEREST (Sept. 16, 2006), <https://www.the-american-interest.com/2006/09/16/a-battle-paul-wolfowitz-cant-win>.

announcing the approval of debt relief for the Republic of Congo and emphasizing that country's commitment to addressing corruption in its oil sector so that "resources [would] not be hijacked by vested interests."¹⁹⁴ The court concluded that "[t]he profits of Coltrade's oil sales should go to the people of the Congo, not to those who rule it or their families."¹⁹⁵

The litigation exemplifies how creditors can challenge, through the courts, the framing of the dispute and even norms of broader relevance than the core underlying legal dispute. The official sector, and most private-sector creditors, were prepared to forgive most of the country's debt, and the multilateral financial institutions were preparing a debt-relief package. The existence of severe corruption in the country was no secret. However, the public sector supported a soft response and was willing to accept commitments by the government to reduce corruption over the long term in exchange for immediate debt forgiveness and aid. The prospect of public-sector carrots and sticks induced most private-sector creditors to accept this approach, but Kensington rejected it. Kensington advocated a harder line against Congo and, rhetorically, against corrupt regimes generally.¹⁹⁶

Using the courts as a platform, and the information obtained through litigation as supporting reasons, it advocated a fundamentally different normative approach to sovereign debt obligations. It framed the soft approach of the official sector as promoting theft from the people of Congo and donor-country taxpayers. It found allies in transparency NGOs, equipped them with the information revealed through discovery,¹⁹⁷ and received the UK court's imprimatur on its assessment of the situation. The litigation led to action in the UK Parliament and U.S. Congress.¹⁹⁸

The creditor also kept its perspective salient among financial market actors. Coverage by a sovereign investment research firm of Congo's restructuring agreement with private-sector creditors exemplifies how litigation supported creditors' persistent

194. See *Long Beach Ltd. v. Glob. Witness Ltd.* [2007] EWHC 1980 (QB), [47] (Eng.).

195. See *id.* at [49].

196. Friedman, *supra* note 173.

197. Interview with Senior Anti-corruption Activist (July 18, 2017).

198. See *supra* note 172 and accompanying text.

opposition to the prevailing norm of debt forgiveness despite known corruption. An article announcing the country's bond issue was titled, "Congo Debt Deal Fuels Debate: IMF Praises London Club Restructuring, but Doubts Raised on the Government's Use of New Funds."¹⁹⁹ The article features laudatory statements by a private-sector creditor that participated in the restructuring and by the IMF about the government's handling of the restructuring. But those statements are counterweighted by the skepticism of a Global Witness representative and a description of the country's efforts to obtain an injunction to block the NGO's publication of documents obtained through litigation by Kensington showing corruption.²⁰⁰ The Global Witness representative highlighted that information revealed by Kensington's litigation falsified other assurances the government gave to the IMF.²⁰¹

Sovereigns pursuing counter-reputational strategies against holdouts face an additional difficulty when those creditors succeed in court. During its disputes with distressed debt funds, Argentina disparaged the hedge funds as illegitimate "vultures" and eventually expanded its attacks to include U.S. courts and Judge Griesa of the Southern District of New York.²⁰² Argentina's sustained attacks on the courts reportedly helped drive the judge to fashion the powerful equitable remedy that accompanied the *pari passu* ruling.²⁰³

D. Other Mechanisms

At least two other informational mechanisms might be at work. The first is the ability of litigation to increase the salience of a dispute with potential investors and other relevant publics, such as those of donor and debtor countries. A sovereign incurs additional

199. Philip Alexander, *Congo Debt Deal Fuels Debate: IMF Praises London Club Restructuring, but Doubts Raised on the Government's Use of New Funds*, GLOBAL CAP. (Dec. 13, 2007), <http://www.globalcapital.com/article/yvy2gx7nmh8h/congo-debt-deal-fuels-debate>.

200. *Id.*

201. *Id.*

202. See Joseph Ax & Andrew Chung, *Argentina Threatened with Contempt Order by U.S. Judge*, REUTERS (Aug. 8, 2014), <http://www.reuters.com/article/us-argentina-debt-idUSKBN0G81GB20140809>; *Economía: "Nuevamente, Griesa llama a una audiencia y no resuelve absolutamente nada"* [The Economy: "Once Again, Griesa Calls a Hearing and Resolves Absolutely Nothing"], 91.1 FM RADIO SIETE (Sept. 8, 2014), <http://radiosiete.com.ar/economia-nueva-mente-griesa-llama-a-una-audiencia-y-no-resuelve-absolutamente-nada/>.

203. Interview with Senior Sovereign Debt Lawyer I (July 12, 2017).

reputational costs as the allegations against it are made newly salient each time a plaintiff initiates a new action against it or succeeds in some phase of litigation. A creditor can use the occasions of milestones in litigation to draw renewed media attention to a dispute. As a senior sovereign debt lawyer explained,

A skillful [plaintiffs'] lawyer will do something that gets a front-page headline every six months. This tends to scare prospective investors and prospective underwriters. It generally lends a sense of being under siege to the country. That will be inconsistent with the next Minister of Finance's desire to portray Ruritania as open for business²⁰⁴

This mechanism was at work during the holdouts' relentless pursuit of Argentina across continents for years until the state finally settled. As another senior sovereign debt lawyer explained,

[They go] to court to highlight that this is a deadbeat debtor; get a judgment against them and publicize it The creditors knew full well that some 15-year-old Argentine frigate is not going to help them recover billions of dollars of debt. It got them tons of publicity; it was embarrassing.²⁰⁵

This dynamic might be attributed to an emotional aspect of reputation that allows court drama to escalate negative reputational signals.²⁰⁶ But it is not necessary to resort to emotion-based theories to explain why litigation can increase the salience of a breach. Litigation has high salience because of the unique institutional features of courts discussed above. The "public-ness" of courts, especially, gives litigation greater salience, in two senses. Courts put information about the dispute into the public domain, making it easier for the press and other information disseminators to report on the dispute.²⁰⁷ Additionally, much of the public views courts as institutions that do, or are supposed to, impartially apply widely accepted rules of behavior, determine the truth, and offer

204. *Id.*

205. Interview with Senior Sovereign Debt Lawyer II (July 19, 2017).

206. See generally ROBERT H. FRANK, PASSIONS WITHIN REASON: THE STRATEGIC ROLE OF THE EMOTIONS (1988) (describing how emotions affect reputation apart from objective considerations).

207. Email exchange with Felix Salmon (July 28, 2017) (on file with author).

recourse for wrongs.²⁰⁸ That perception of the role of courts gives their decisions on disputes between particular parties a moral weight that makes the public more attentive to judicial pronouncements than it is to pronouncements of other institutions on the same dispute.

A second mechanism is national pride. While standard economic theory predicts that the effectiveness of reputation is determined by its effect on future transactions, it might also be that pride in the standing of one's nation in the world drives decisions about whether to repay creditors. All else equal, this factor could cut either in favor of or against repayment. Many observers view the temporary arrest in Ghana of an antique Argentine navy frigate because of creditors' actions as a deep wound to Argentine national pride.²⁰⁹ Some countries are said to scrupulously repay debts because they want to be seen as, and see themselves as, the kind of nation that repays debts.²¹⁰ To the extent this factor is at play, it might increase the leverage creditors get by calling debtor nations to account for their behavior and embroiling them in litigation in courts around the world.

E. Information Provision as a Public Good

Norm shaping and the public provision of information relevant to third parties are public goods and, therefore, might be expected to be underprovided. I use the term "public good" as it is used in economic parlance—to refer to things that satisfy human wants and are both non-excludable and non-rivalrous—without taking a position on whether the shaping of norms by sovereign creditors is good as a matter of morality or public policy. One market

208. See Judith Resnik, *The Contingency of Openness in Courts: Changing the Experiences and Logics of the Public's Role in Court-Based ADR*, 15 NEV. L.J. 1631, 1639–40 (2015); Tom Tyler & Justin Sevier, *How Do the Courts Create Popular Legitimacy?: The Role of Establishing the Truth, Punishing Justly, and/or Acting Through Just Procedures*, 77 ALB. L. REV. 1095 (2014); *The State of State Courts: A 2014 NCSC Public Opinion Survey*, NAT'L CTR. FOR ST. CTS., <http://www.ncsc.org/2014survey> (last visited Oct. 8, 2018).

209. See, e.g., Ed Stocker, *Argentina Welcomes Home Ship Held in Ghana by US 'Vulture Fund'*, UK INDEPENDENT (Jan. 9, 2013), <https://www.independent.co.uk/news/world/americas/argentina-welcomes-home-ship-held-in-ghana-by-us-vulture-fund-8445151.html>.

210. Cf. ADAM SMITH, *THE THEORY OF MORAL SENTIMENTS* (D.D. Raphael & A.L. Macfie eds., Clarendon Press 1976) (1759) (arguing that people desire the moral approbation of others and wish to see themselves as worthy of that approval).

participant put the point aptly: “They’re not trying to change the course of society; they want to get paid.”²¹¹

From the litigating creditor’s point of view, a collective action problem might appear in this context as follows: creditors could hold their debt and wait for one creditor to litigate to develop the law or frame the dispute in a manner that puts pressure on sovereigns to settle with creditors. The litigating creditor would then not reap the entire benefit of suing and, therefore, might sue less often than would be efficient. The potential for free riding is greatest in the early phases of litigation, when issues of law and fact that are common to multiple creditors have not yet been resolved. For example, the champerty issue was an open legal question that, once resolved in favor of particular holdouts in early cases, created precedent that benefitted other holdouts.²¹²

This incentive structure is present in litigation generally and is not limited to reputation-driven litigation. Several factors mitigate the collective action problem in the context of distressed sovereign debt. Holding out against sovereign debtors is a high-risk investment strategy pursued nearly exclusively by a handful of specialized investment funds that buy distressed sovereign debt on the secondary market. They are long-term, repeat players who have incentives to invest in developing the law, establishing their reputations as aggressive creditors and reframing sovereign debt disputes as contests between corrupt governments and good-faith creditors. The expertise required to be a successful distressed sovereign debt investor imposes high startup costs to entering the market.²¹³ Moreover, many institutional investment funds have regulatory incentives and strategy mandates that cause them to sell debt that is in default or whose credit rating drops below a certain

211. Interview with Senior Market Participant I (July 18, 2017).

212. See discussion, *supra* notes 148–154 and accompanying text.

213. See Interview with Senior Sovereign Debt Professional (July 22, 2017) (“[T]he bulk of the market are people who buy, sell, trade, and have mandates or certain funds that say things they can and can’t do The bulk of the market simply does not have the mandate to be holdouts.”); Interview with Investment Analyst (May 28, 2017); Kate Allen, *Venezuela Debt Reaches Flashpoint in Political Crisis*, FIN. TIMES (Aug. 11, 2017), <https://www.ft.com/content/2f3beaa0-7c59-11e7-ab01-a13271d1ee9c> (quoting fund portfolio manager saying “that the due diligence and monitoring needed to keep up to date with the risks” of Venezuela’s debt “are excessive” for many emerging market bond investors and that distressed debt investors are entering the market for Venezuelan debt).

threshold.²¹⁴ This market structure enables specialized distressed debt investors to maintain supernormal profits that counteract the collective action problems posed by investing in litigation.

Additionally, much of the leverage gained by distressed debt investors derives from their ability to establish themselves as credible “squeaky wheels.” This is especially true in disputes with so-called recalcitrant debtors. Some of the most experienced sovereign debt litigators explained their approach:

The strategy that is devised to get payment is not just focused on particular assets to be found outside the country at issue but to allow the political forces at play within the country to know that this is an obligation that needs to be dealt with . . . that it’s in their interest to deal with us rather than to not deal with us.²¹⁵

Other creditors who might seek to swoop in when an aggressive holdout is on the verge of settling will not have the same credibility as entities that must be dealt with. Consider creditors that pursue a strategy of uncovering corruption. Their leverage over the government is the threat of continuing to pursue discovery through enforcement actions that will uncover additional information about corruption. The litigating creditor’s past success and demonstrated willingness to pursue this strategy aggressively are specific to it. Moreover, the creditor might have information it has not made public that poses a credible threat of likely further success through continued discovery. All of those factors limit the ability of other holdouts to free ride on one holdout’s litigation victories. Finally, courts have declined to grant relief to free-riding creditors that have attempted to collect damages based on the success of holdouts in achieving settlement.²¹⁶

IV. CONCLUSION

The account given here of the function of courts in the sovereign debt market speaks to debates in the economics literature on

214. See Partnoy, *supra* note 122, at 690; Interview with Investment Analyst (May 28, 2017).

215. Interview with Senior Sovereign Debt Lawyers III and IV (July 29, 2017).

216. See *White Hawthorne, LLC v. Republic of Arg.*, No. 16-cv-1042, 2016 WL 7441699 (S.D.N.Y. Dec. 22, 2016) (dismissing action by bondholders that first sued Argentina in 2016, when settlement was pending, claiming that the *pari passu* clause in their bonds entitled them to payment along with Argentina’s settlement with the litigating holdout creditors).

sovereign debt and offers broader lessons about reputational enforcement and the role of courts in dispute resolution.

A body of research on the economics and law of sovereign debt attributes to reputation a dominant role in sustaining the sovereign lending market.²¹⁷ Courts are recognized as playing a marginal role as an institution with limited coercive sanctioning power.²¹⁸ The two mechanisms of litigation and reputation are seen as occupying separate hemispheres. On this view, creditors rely heavily on reputation to incentivize repayment, and they can increase pressure if necessary by layering on legal costs.²¹⁹ Some scholars of sovereign debt have even challenged reputational theories by arguing that such theories cannot explain why sovereigns would offer creditors recourse to foreign courts.²²⁰

This Article builds on the literature attributing the functioning of the sovereign debt market to reputation, while also accounting for the market's observed recourse to the law and courts. Whereas reputation and legal enforcement have long been conceived of as substitutes or, at most, complements that work through different mechanisms, this Article shows that courts can play a key role in reputational governance.

In addition, this Article offers a thicker description of how reputation operates in the sovereign debt market. This fuller account speaks to additional questions raised in the theoretical and empirical literature about whether reputation can really be effective in sustaining the observed levels of lending to risky sovereigns. Reputational accounts of sovereign lending have been challenged on theoretical grounds. One argument is that states that renege on their debt can turn to self-insurance. That is, they can use excess cash available in good times to buy financial assets and then rely on the returns from those assets in bad times. Because sovereigns can turn to self-insurance, they have the option of breaching their debt contracts and then withdrawing from lending markets.²²¹ Another

217. See Panizza et al., *supra* note 1; Jeremy Bulow & Kenneth Rogoff, *Sovereign Debt: Is to Forgive to Forget?*, 79 AM. ECON. REV. 43, 43 (1989).

218. See *supra* note 2 and accompanying text; Introduction.

219. See Panizza et al., *supra* note 1, at 1, 14.

220. See REINHART & ROGOFF, *supra* note 2, at 56.

221. See Bulow & Rogoff, *supra* note 6.

objection to reputational theories is the possibility that a future government might not value access to capital markets.²²² Some scholars have questioned reputational accounts on empirical grounds because some studies have found that defaulting states do not face extended exclusion from capital markets or significantly higher borrowing rates.²²³

The broader account of reputation presented here responds to those challenges by showing that the reputation that matters is not only reputation with prospective lenders. This account moves beyond a unitary model of the state and accounts for a broader set of incentives facing the agents of the state who decide whether to pay foreign creditors. In addition to capital markets, politicians face potential consequences in domestic politics and international relations. The existence of multiple relevant social fields populated by actors having non-identical preferences increases the options available to creditors for exerting reputational pressure, including through litigation.

This Article does not claim that reputation is the sole enforcement mechanism in the sovereign debt market. It does not argue that the only thing that creditors are seeking or that courts are providing in sovereign debt litigation is information that will damage the debtor's reputation. It does not estimate what proportion of lending to sovereigns is supported by reputational enforcement, what proportion is supported by reputational enforcement specifically aided by courts, or what proportion of sovereign debt litigation is explained by reputational enforcement. What it does is show, through a thick empirical description that comports with theoretical predictions, that courts play a pivotal role in reputational enforcement in a market that is widely recognized to depend heavily on that type of enforcement. It thereby sheds new light not only on how sovereign debt markets function but also on how reputation operates and how courts influence behavior in markets.

Contracts scholars have studied an array of cases in which close-knit communities and industries characterized by repeat play function because of reputational enforcement. As these informal

222. See REINHART & ROGOFF, *supra* note 2, at 55.

223. See Tomz & Wright, *supra* note 46, at 247, 260–61.

economic exchange networks become more complex, reputation is sometimes supported by private arbitration based on rules chosen by industry players. The case of sovereign debt illustrates that reputation supported by a legal adjudicator can work in an additional set of cases. The case study presented here suggests a framework for assessing the likely effectiveness of courts as reputation intermediaries in a given market or social field. Courts will tend to be effective as information intermediaries when information dissemination costs are low, the economic costs of reputational damage are high, and verification costs are high but are relatively lower for courts than for other information intermediaries. Additionally, the value at stake must be sufficiently high to render a non-breaching party's threat to litigate credible.

Those general criteria can be made more specific. Adjudication without enforcement is more likely to be an effective form of governance when market participants are less anonymous, have longer time horizons, have more homogeneous preferences, and are subject to greater reputation spillover effects. The ability of courts to provide information relevant to actors in multiple social fields in which market participants operate increases their effectiveness as reputation intermediaries. So does the ability of courts to produce information that is central to the concerns of third parties, with the power to sanction or refuse to deal with a breaching party, where those third parties are not particularly concerned about the breach that forms the core of the dispute.²²⁴ This latter capacity becomes more important as the preferences of prospective transactors become more heterogeneous.

Are there things that can be done to expand or contract the scope of governance by reputation through adjudication? A first step toward increasing the scope of reputation adjudication in commercial transactions would be to increase the transparency of dispute resolution. Policymakers and scholars have raised concerns about the secrecy of arbitration. But state and federal courts decide a large percentage of matters – as many as ninety-seven percent –

224. In the sovereign debt context, courts have produced information about corruption that hurt government officials' reputation with third parties that were not sympathetic to the creditors' claims. See *supra* notes 158–183 and accompanying text.

without publishing reasoned decisions.²²⁵ One way lawmakers could increase the potential scope of reputational enforcement mediated by courts is by requiring courts to publish decisions.

Lawyers and regulators can increase the salience of judicial decisions through public relations efforts. However, there are limits to this approach, including the attention spans of the press and the public. Some matters attract more attention than others. Nonetheless, a long-term strategy of cultivating public concern about an issue, together with litigation, might hold promise for shaping behavior where existing legal remedies are weak.

Conversely, perhaps policymakers should be more concerned about overdeterrence from litigation's reputation effects. Others have observed that, when calibrating remedies, policy makers should account for reputational effects.²²⁶ This case study offers insights into how policy makers might analyze the reputational impact of litigation and other forms of dispute resolution that release public information about disputing parties.

Finally, the analysis presented in this paper has implications for law and development. The global development establishment has embraced a diagnosis of ineffective or absent contract enforcement institutions as the leading cause of economic underdevelopment. Law reform efforts frequently seek to implement Western-style, formalistic, judicially backed contract institutions.²²⁷ There has been controversy among scholars and practitioners of law and development about the ability to import Western-style legal institutions into non-Western countries. Such efforts might fail because, among other reasons, they conflict with local norms and social structures. While the analysis presented in this paper does not offer a specific prescription for law and development practice, it suggests that law reformers seeking to promote economic development might realize their goal of lowering contracting risk

225. See Hillel Y. Levin, *Making the Law: Unpublication in the District Courts*, 53 VILL. L. REV. 973, 988 (2008); Penelope Pether, *Inequitable Injunctions: The Scandal of Private Judging in the U.S. Courts*, 56 STAN. L. REV. 1435, 1436 (2004).

226. See ROBERT D. COOTER & ARIEL PORAT, GETTING INCENTIVES RIGHT: IMPROVING TORTS, CONTRACTS, AND RESTITUTION 187-206 (2014).

227. Kevin E. Davis & Michael J. Trebilcock, *The Relationship Between Law and Development: Optimists Versus Skeptics*, 56 AM. J. COMP. L. 895, 900-03 (2008); Michael Trebilcock & Jing Leng, *The Role of Formal Contract Law and Enforcement in Economic Development*, 92 VA. L. REV. 1517 (2006).

by tapping into existing local social networks. Institutions that employ court-like information-producing features might raise the cost of breaching contracts even without conventional Western-style enforcement mechanisms.

APPENDIX: METHODOLOGY

The reputational theory of sovereign debt litigation emerged from the observation of published information about the sovereign debt market and related litigation. Published sources included sovereign bond indentures; judicial decisions; scholarly accounts of the market and related litigation; the documentation of relevant institutions such as credit rating agencies, trade associations, and multilateral public-sector lenders; and press reports.²²⁸ I interpreted the information from those sources in light of the assumption that the sophisticated actors in this context are instrumentally rational. I assume, for instance, that investors seek to maximize the value of their investments and that they pursue litigation in service of that end. Public information about sovereign debt disputes suggests that courts might serve a reputational function that holdout creditors view as a means of increasing the returns on their investments. Sophisticated professionals might be expected to be conscious of and able to articulate the strategies they and their organizations pursue to achieve their ends.

Therefore, to check the fit of the reputational theory, I identified interview subjects using a supplemented snowball sampling method.²²⁹ The sample is not random or statistically representative. I sought instead to interview people with experience in each role I had identified as being important to the functioning of reputational enforcement in this context.²³⁰ I sought to ascertain whether the professionals' accounts of their actions and decision-making processes, and those of the organizations they represented, comported with the theory. As I learned more about how reputation functions in this market, about information being provided by courts and other sources, and about how people and organizations

228. For a description of the method of building theory from cases, see Kathleen M. Eisenhardt & Melissa E. Graebner, *Theory Building from Cases: Opportunities and Challenges*, 50 *ACAD. MGMT. J.* 25 (2007).

229. In snowball sampling, earlier interview subjects recommend others for future interviews who have the characteristics of interest for the research. JOHN LOFLAND, DAVID SNOW, LEON ANDERSON & LYN H. LOFLAND, *ANALYZING SOCIAL SETTINGS: A GUIDE TO QUALITATIVE OBSERVATION AND ANALYSIS* 43 (4th ed. 2006). I combined snowball sampling with targeted searches for professionals having experience in relevant roles.

230. Such "purposeful sampling" is appropriate for selecting people who know about the phenomenon of interest, especially where that phenomenon plays out among a small, specialized social group. See JOHN W. CRESWELL & VICKI L. PLANO CLARK, *DESIGNING AND CONDUCTING MIXED METHODS RESEARCH* (2d ed. 2011).

were using that information, I expanded the categories of professional experience from which to seek interview subjects.

I conducted semi-structured interviews with twenty professionals with substantial experience in one of the following activities: advising on sovereign creditworthiness or on whether to buy or sell sovereign debt; deciding whether to buy or sell sovereign debt; deciding whether and how to invest in the territory of a sovereign debtor; suing a sovereign debtor; deciding whether to sue a sovereign debtor; issuing or restructuring sovereign debt; advising on transactions with foreign sovereigns; or providing information about sovereign behavior through an official multi-lateral institution, the press, a trade association, or a non-governmental public interest organization.

Interviews were conducted confidentially to encourage forthrightness, unless the interviewee requested attribution. Interviews were typically forty-five minutes to one hour long, though one was thirty minutes, and several were over an hour. To mitigate the accuracy limits of interview research, where possible I triangulated information obtained from interviews with other sources, including other interviews and publicly available information. The descriptions I use to identify the interview subjects balance offering enough detail to show the basis for their knowledge with protecting their confidentiality. To further protect interviewees' confidentiality, I use male pronouns for all interview subjects.