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The Relevance of Law to Sovereign Debt

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Abstract

The literature on sovereign debt treats law as of marginal significance, largely because the doctrine of sovereign immunity leaves creditors few potent legal remedies against sovereign borrowers. Although sovereign debts can indeed by hard to enforce, the goal of this Essay is to demonstrate that law plays a central, and constantly evolving, role in structuring sovereign debt markets. To list just a few examples, legal rules and institutions (i) decide when a borrower is sovereign, (ii) define the consequences of sovereignty by drawing (or refusing to draw) artificial boundaries between the sovereign and other legal entities, (iii) play some role in cases of state and government succession, and (iv) determine the extent to which the rules of sovereign immunity can be changed by contract. These legal rules and institutions are not set in stone; they evolve in response to the political, economic, and social forces that shape the market for sovereign debt.

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1. Introduction

The literature on sovereign debt tends to downplay the relevance of law and legal actors, focusing instead on broader economic and political considerations. One reason for this is that creditors cannot easily enforce their claims through the courts; sovereigns have historically enjoyed absolute or partial immunity from coercive legal enforcement. Despite this, sovereign debt markets have thrived for centuries. Indeed, sovereign debt is often considered to be among the safest of investments. Why should this be? This is perhaps the central question in the sovereign debt literature. Answers vary, but most academic treatments of the subject conclude that loans to sovereigns are enforced through non-legal mechanisms such as reputational or trade sanctions.

The absence of a formal mechanism for sovereign bankruptcy raises another key question: How can a sovereign restructure its debt? Implicitly, the literature seems to assume that sovereigns and their debts last forever. That is, a sovereign's debt obligations pass from one generation to the next until the debt is repaid or until the sovereign reaches some accommodation with creditors through ex post negotiation. This view naturally inclines observers to examine the economic and political factors that influence bargaining over a restructuring, such as whether lenders can effectively coordinate to deny future loans to a recalcitrant debtor. Consequently, the law again takes a back seat in the academic literature. There are exceptions. For example, a recurring question has been whether loan contracts can be designed to make debt restructuring more efficient without unduly increasing moral hazard (e.g., Eichengreen 2003). Yet the literature seemingly rejects the possibility that the law might play a deeper, more constitutive role.

Although we have no quarrel with the general narrative in the sovereign debt literature, our goal in this essay is to suggest that law is more important than is often assumed. The two core assumptions of the sovereign debt literature—that sovereigns and their debt last forever and that legal enforcement does not matter—are themselves the product of law. So too are many foundational questions that are often overlooked by the literature.

In theory, any discussion of sovereign debt should begin by asking, what is a sovereign? But this rarely happens, perhaps because the answer seems obvious in many cases. There is universal agreement that some geopolitical entities—say, nations like Greece—qualify as sovereign states. Yet the very idea that some entities are "sovereign," while others are not, is a legal fiction, and the boundaries to this fictional territory are actively contested. Political, economic, and historical factors influence the outcome, but in modern times legal actors play an outsized role. Provinces, cities, international organizations, development banks, state-owned enterprises, and even privately-owned entities all may plausibly claim some degree of sovereign status under certain conditions.

Alternatively, consider questions of state and government succession. State succession involves a transfer of responsibility for the international relations of a territory. Examples include the emergence of a new state and the annexation of territory by another state. Such events raise basic legal

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questions, including whether the successor state is responsible for debt attributable to the (formerly non-sovereign) territory. At present, the answers to such questions primarily result from ad hoc, ex post negotiations in which economic and political considerations are the main drivers. But legal actors and legal rules can play an important mediating role.

The same is true in cases of government succession. It is usually taken for granted that a sovereign's debt obligations survive the transition from one set of political leaders to another. But what happens when the government in question is quite clearly unrepresentative of the citizenry? Must citizens repay debt incurred only nominally in their behalf by despotic former political leaders? As a practical matter, the answer is "sometimes not." The exceptions result from ex post negotiations between lenders and the sovereign's new political leadership, and these discussions are framed by legal rules and institutions. These include the long-standing rule that governments inherit the debts of prior governments—which many argue should be qualified in cases involving "odious" debts—and the courts that must determine how vigorously to enforce creditor demands for repayment. That role calls on courts to interpret and apply, and perhaps even to change, another critical legal doctrine: sovereign immunity.

Sovereigns have historically enjoyed absolute immunity from coercive methods of legal enforcement, such as asset seizure and liquidation. Even today they retain significant aspects of this immunity. Consequently, the conventional wisdom is that legal enforcement plays little to no role in the sovereign lending context. But conventional wisdom understates the potential relevance of legal enforcement. Among other reasons, this is because creditors can contract ex ante for enhanced enforcement rights. As we will explain, whether these ex ante commitments materially improve a creditor's position depends on whether courts will enforce them, and the law here is in flux. Because the literature pays little attention to sovereign loans as *contracts* (Weidemaier and Gulati 2015), it does not account for this possibility.

It is clear that law *can* meaningfully affect sovereign debt obligations. After all, the chorus of voices asking for a system of sovereign bankruptcy—where a "court" established by multilateral treaty would oversee a debt restructuring—has been steadily increasing. A formal and binding bankruptcy regime would place law front and center in discussions of sovereign debt. We use this essay to highlight other ways in which the law can and does shape sovereign debt. We first review the literature, keeping this discussion brief in light of thorough recent treatments by Tomz and Wright (2013), Oosterlinck (2013); Panizza et al. (2009), and Reinhart and Rogoff (2009). We then identify and explore a number of areas in which the law plays a crucial role in the sovereign debt markets. We begin with the legal fiction of sovereignty, highlighting both the uncertain boundaries of the term and the multitude of legal questions that remain once an entity is found to meet the definition. We then explore the law's role—so far modest, but potentially significant—in cases of state and government succession. Our last example involves legal enforcement. We show that, at least in theory, sovereigns can bestow potent enforcement rights on their creditors ex ante. Throughout, we keep our discussion of legal doctrine brief; our primary goal is to highlight the relevance of law in these areas.

We conclude with a more general insight. In recent years, a growing number of academic papers acknowledge the possible relevance of law, particularly in the context of debt workouts. This is a welcome development. At least implicitly, however, the literature views law as exogenous, as the product of factors external to the broader "system" of sovereign debt. Yet this is surely incorrect. As just one example, as barriers to migration lessen, birth rates fall, and countries become increasingly burdened by debt, citizens may grow less willing to shoulder the burden of debts incurred by prior generations. We have little doubt that an economist or political scientist would view such developments with interest. It bears emphasis, however, that such developments are of equal relevance to the *law* of sovereign debt. As just one example, we might expect legal actors to take more seriously claims that newly emerged states do not bear responsibility for prior debt obligations. The relevant legal rules are not set in stone but may change in response to the broader economic, political, and other forces that shape the market for sovereign debt.

2. A (brief) review of the literature

Several recent reviews discuss the extensive literature on sovereign lending in economics, political science, and (to a lesser degree) law (Gaillard 2014, Tomz and Wright 2013, Aguiar and Amador 2013, Panizza et al. 2009, Reinhart and Rogoff 2009). We provide a truncated summary of this literature elsewhere, where we also explain why sovereign loan contracts merit more attention than they have so far received (Weidemaier and Gulati 2015). Thus, we keep our discussion in this section brief. Our primary goal is to emphasize that the literature pays little attention to law and legal actors. This is true even though the literature is founded on the presumed consequences of a legal rule: the rule of sovereign immunity.

The rule that sovereigns are immune from coercive legal enforcement is a rule of customary international law, which is defined as the general and consistent practice of states followed from a sense of legal obligation. Traditionally, sovereigns had absolute immunity from suit and from having their assets seized to satisfy a judgment. As it is usually understood, however, the "absolute" rule of immunity was not really absolute; the rule was a default. A sovereign could waive its immunity and agree to be sued, although in some jurisdictions it might have been allowed to retract the waiver later (Weidemaier 2014). And, of course, lenders could find ways to protect themselves notwithstanding the doctrine. Famously, in the 1870s, the Khedive of Egypt put up his personal lands as surety for foreign borrowers and even set up special courts to hear creditor claims (Esteves and Tuncer, 2013).

In the United States and United Kingdom, the doctrine of absolute immunity began to erode in the latter half of the twentieth century; the transition began much earlier on the European continent (Verdier and Voeten 2014). As noted above, this transition represented a shift in the default rule. Under the absolute immunity doctrine, sovereigns were presumptively immune from suit even when engaged in commercial activity abroad, but they could waive this immunity by contract (Verdier and Voeten 2014). Under the modern, "restrictive" theory of immunity, sovereigns are presumptively *not* immune from suit for commercial acts. In other work, we have questioned parts of this understanding, arguing that it may not have been as easy for parties to waive sovereign immunity by contract as current accounts suggest (Weidemaier and Gulati 2015). Nevertheless, it is clear that sovereigns have gradually become more amenable to suit by private creditors.

Despite the dramatic shift from absolute to restrictive immunity, the default rule remains inhospitable to creditors. If the sovereign does not pay, creditors cannot easily enforce their claims through the courts, which have little power to force compliance. The reason for this is simple. Because courts cannot direct the seizure of assets in other jurisdictions, a sovereign can protect its assets by keeping them within its borders. Given these difficulties, most observers discount the relevance of legal enforcement (Panizza et al. 2009; Aguiar and Amador 2013). The question is why sovereigns repay at all.

Prevailing explanations focus on non-legal mechanisms. One is reputation; sovereigns repay because they want to preserve access to credit markets and must be viewed as trustworthy to do so (e.g., Tomz 2007). A second emphasizes the possibility that default might prompt creditors and other outsiders to retaliate, as by denying trade credit or disrupting trade relations (Sachs and Cohen 1982, Bulow and Rogoff 1989a, Bulow and Rogoff 1989b). Yet a third emphasizes the collateral economic and political costs of default on the borrower and its governing officials. For example, default might magnify output losses associated with financial crisis via mechanisms such as domestic banking crises (Panizza et al. 2009, Gennaioli et al., 2014). None of these explanations leave much role for the law or for legal actors.

Beyond focusing on why sovereigns repay, the literature also examines problems associated with restructuring sovereign debt. In cases of genuine financial distress, restructuring can benefit both the debtor and its creditors. Yet if restructuring is too easy, an opportunistic debtor may try to reduce its debt when it is able to pay. In a private loan, bankruptcy law balances these concerns and establishes relatively clear ground rules that allow lenders to evaluate and price default risk ex ante. But this task is more difficult when the loan involves a sovereign, for there is no bankruptcy mechanism for comprehensively adjusting a sovereign's debt. Nor is any creditor obliged to reduce its claims against the sovereign (unless the loan contract provides a mechanism for imposing restructuring terms on unwilling creditors). This gives creditors an incentive to hold out from a restructuring in the hope of receiving a disproportionate share of the funds the sovereign is able and willing to pay (Eichengreen 2003).

There is by now a large literature exploring how and why sovereigns restructure and what factors influence restructuring outcomes. For example, many observers feared that the shift from syndicated bank loans to bond lending in the 1990s would delay restructuring negotiations and allow sovereigns to impose coercive restructuring terms. These fears stemmed from the insight that, unlike a few concentrated bank lenders, a country's many and dispersed bondholders would find it difficult to coordinate their response to default (Panizza et al., 2009). Yet recent research provides limited support for these fears (e.g., Bi, Chamon, and Zettelmeyer 2013, Enderlein, Müller, and Trebesch 2008). If anything, a number of scholars have turned 180 degrees to posit that the central problem in sovereign debt restructuring is not that sovereign issuers will restructure opportunistically (too early, too often), but that they will wait too long to restructure (Brookings Institution 2013). The underlying dynamics of the "too little, too late" claim have not yet been rigorously examined. But the simple version of the story has to do with agency costs. Government officials who announce a restructuring face high personal costs—potential loss of power—and therefore delay the restructuring, hoping to right the ship through risky economic policies that may ultimately disadvantage creditors and citizens alike.

These inquiries into why sovereigns repay and how they restructure generally do not assign the law a meaningful role. To be sure, a voluminous literature debates the merits of a formal sovereign bankruptcy regime (Eichengreen 2003, Bolton 2003, Hagan 2005, Hagan and Krueger 2005). In other respects, however, the law and legal institutions attract little attention. For example, the literature pays little attention to the terms of loan contracts. Yet we know that investors tend to demand numerous contractual protections from all but the most creditworthy of sovereign issuers. These protections include detailed clauses governing the scope of the sovereign's waiver of immunity, the location for any enforcement litigation, the law that will govern disputes, and a range of other enforcement-related terms. If the law does not matter, it is hard to understand the justification for all of these contractual protections (Weidemaier and Gulati 2015).

This is not to say that the literature is completely indifferent to loan terms. The so-called "original sin" (Eichengreen et al. 2003) in the sovereign debt markets involves the inability to borrow abroad in domestic currency, and currency-of-payment is a term specified in the contract. Researchers have also noted the relevance of loan maturity, noting that weaker sovereign issuers may have to issue shorter-term debt (e.g., Arellama and Ramanarayanan 2013, Jeanne 2009). In addition, there are two other prominent exceptions to the literature's general indifference to the law.

First, a sizeable body of research examines so-called collective action clauses (CACs): contractual mechanisms for simulating a bankruptcy cram-down process in which recalcitrant minority creditors are obliged to accept restructuring terms (Gelpern and Gulati 2006). A number of studies examine whether sovereigns who adopt such a mechanism suffer a pricing penalty, reporting somewhat mixed results (Eichengreen and Mody 2004, Becker et al. 2003, Weinschelbaum and Wynne 2005, Richards and Gugiatti 2003, Bradley and Gulati 2014, Bardozzetti and Dottori 2014). Second, several studies address whether investors demand a premium to hold bonds governed by the sovereign's domestic law, relative to bonds governed by foreign law (Chamon et al., 2014; Clare and Schmidlin 2014). Such a premium would reflect the increased risk associated with holding debt governed by the sovereign's own law, which the sovereign can manipulate to reduce its obligations to creditors. As an example, in March 2012 Greece changed its law to impose restructuring terms on investors who held local-law sovereign bonds, while maintaining full debt service on most of its foreign-law debt.

These are welcome exceptions, but they operate at the margins. As we discuss below, the law plays a more central role in the sovereign debt markets than is typically assumed.

3. On legal fictions: Sovereignty and separate legal personhood

The academic literature on sovereign debt generally does not examine the nature of sovereignty, implicitly treating this characteristic as self-evident (Lienau 2008). A typical approach assumes that the borrower enjoys the legal attributes of sovereignty and then examines one of the many resulting puzzles, such as how such an entity can borrow or restructure (e.g., Bulow and Rogoff 1989a). But sovereignty is not self-evident, nor are the consequences of that status.

Most lawyers would recognize the label "sovereign" as a fiction in which the state is treated as a legal "person" separate and apart from its citizens. Once an entity is labeled a sovereign, certain consequences follow, such as the right to assert immunity from legal enforcement. Yet it is not always clear when the label applies. Sovereign states have common attributes, such as defined territory and a permanent population.[1] Despite these similarities, the fundamental reason why an entity enjoys the benefits of sovereignty is because some relevant (often legal) actor has determined that it is entitled to them. Take Puerto Rico, which is neither a US state nor a foreign state under US law. Although this would seem to defeat any claim to sovereign immunity, courts have nevertheless allowed Puerto Rico to claim the benefit of the doctrine (e.g., Torres-Alamo v. Puerto Rico, 502 F.3d 20 (1st Cir. 2007)). (It is not clear, however, that this will protect the territory or its instrumentalities in litigation resulting from a default on its debt.)

[1] Under international law, a "state" is an entity with a defined territory and permanent population, under the control of its own government, that engages in or has the capacity to engage in formal relations with other such entities. Restatement (Third) of the Foreign Relations Law of the United States § 201. As is apparent from the definition, it is not always easy to tell whether these elements are satisfied.

It is not unusual for the law to extend a benefit of sovereignty—such as immunity from coercive legal remedies—to an entity that is indisputably *not* a state. For example, US law extends sovereign immunity to the agencies and instrumentalities of a foreign state, defining these terms to include both state-owned entities and entities that act as an "organ" of a foreign state (28 U.S.C. § 1603).[2] Thus, a state-owned corporation may assert sovereign immunity in a lawsuit brought by its creditors (e.g., Gates v. Victor Fine Foods, 54 F.3d 1457 (9th Cir. 1995)).

When it extends the benefits of sovereignty to non-state actors, one might say that the law dispenses with the fiction of separate legal personhood. For instance, State A may treat corporations and other (fictitious) entities within its borders as separate legal persons—separate from each other and from the state itself. If State B extends sovereign immunity to these entities, it chooses to overlook these fictitious boundaries, presumably because doing so furthers the purposes underlying the law of sovereign immunity. In other contexts, however, the law may rigorously maintain boundaries between states and the fictional entities they create. As an example, consider whether State A's creditors may seize the assets of a state-owned entity.

Creditors of a sovereign face a dilemma. Even if they win a court judgment, sovereign immunity limits the ability to seize sovereign assets. Under the rule of absolute immunity, a sovereign can conduct even commercial transactions abroad without fear that its assets will be seized to satisfy a creditor's judgment. Under the modern, restrictive theory of immunity, creditors can seize commercial but not governmental assets.[3] This means that, to keep its commercial assets safe, the sovereign must keep them within its own borders (assuming its domestic courts lack the authority or the inclination to enforce foreign creditor claims). The result of a foreign court judgment, then, is a creditor-imposed embargo on the sovereign's foreign commercial transactions (Weidemaier and Gelpern 2014, Weidemaier and Gulati 2015). This provides some incentive to repay, but the incentive is generally thought to be modest (Panizza et al. 2009).

The reason the incentive is modest, however, is that, in this context, the law maintains the fiction of separate legal personhood. As a result, creditors of a sovereign usually cannot enforce their claims against state-owned enterprises or their assets (e.g., La Générale des Carrières et des Mines v F.G. Hemisphere Associates LLC, [2012] UKPC 27). If court judgments are enforced by embargo, this legal fiction (that state-owned enterprises are distinct from the sovereign itself) dramatically limits the scope of the embargo. The result is that the sovereign may conduct foreign commerce through entities over which it exercises substantial, if not complete, control.

The strength of a legal fiction, however, depends on the willingness of legal actors to sustain it. As any student of corporate law will point out, legal personhood is a privilege granted by the state to promote some broader public interest. And to the extent an entity abuses this legal fiction, the privilege may be withdrawn. In the corporate context, for example, courts sometimes hold shareholders liable for the corporation's debts. This is classic veil piercing (Bainbridge 2001).

By contrast, the phenomenon we refer to is akin to what a corporate lawyer would call "reverse veil piercing." In this scenario, the corporation is liable for the debts of a shareholder. In the sovereign context, examples include cases in which creditors of Argentina have pursued assets of the Argentine National Space Activities Commission; creditors of Cuba have pursued assets of the state-owned

[2] It can be difficult to determine what constitutes an "organ" of a foreign state (e.g., European Community v. RJR Nabisco, Inc., 764 F.3d 129 (2014); Bank of New York v. Yugoimport, 745 F.3d 599 (2014)).
[3] This is, at least, the default rule. In Part 4, we discuss whether sovereigns can waive immunity for governmental assets.

airline; and creditors of Cameroon, the Democratic Republic of the Congo, and other countries have pursued assets of state-owned companies. A similar kind of veil piercing has been proposed for cases in which despotic governments leave exorbitant debts for future governments to pay (Buchheit et al. 2001)). Thus far, such veil piercing arguments have met with limited success. Nevertheless, the doctrine is evolving, we suspect in a way that will enhance the ability of a sovereign's creditors to reach assets of other entities. To the extent this happens, a creditor's judgment against a sovereign will result in a much more expansive and potent embargo.

One can also imagine cases akin to traditional veil piercing, in which creditors of a state-owned or state-controlled enterprise are allowed to enforce their claims against the sovereign itself. Say a state-owned corporation, such as the Russian-owned Rosneft, defaults on a sizeable debt that the Russian government has not explicitly guaranteed. In some contexts, creditors of the state-owned entity may look to the sovereign for satisfaction. These include cases in which the state effectively controls the entity's day-to-day activities (e.g., La Générale des Carrières et des Mines v F.G. Hemisphere Associates LLC, [2012] UKPC 27).

In sum, sovereignty and its consequences depend on a series of legal fictions, which can be applied in ways that appear contradictory. For example, a state-owned enterprise can assert sovereign immunity against its own creditors while insisting that creditors of the sovereign must respect its separate legal status. We do not claim these results are illogical, only that they are not inevitable. The definition of sovereignty, and the consequences of that status, are actively contested, and it is reasonable to think that the rules may change.

4. The infinite life of sovereigns and their debts

Sovereigns undergo frequent and sometimes tumultuous transitions. In addition to ordinary political transition, there is war, invasion, revolution, ethnic conflict and more. As a result, sovereigns lose and add territory regularly. Even when physical territory is constant, social identity (for lack of a better phrase) can change. The UN had 51 members in 1945; it has almost four times that number in 2014.

Traditionally, observers have drawn a distinction between government succession, involving transition between political leaders, and state succession, involving transitions in sovereignty over territory. The dissolution of the former Socialist Federal Republic of Yugoslavia is an example of the latter. Government succession is of course routine, and although state succession is comparatively rare, it is not uncommon and often entails significant conflict and turmoil. What effect should such transitions have on the territory's debt obligations? The usual presumption is: none. Sovereigns do not die and cannot file for bankruptcy, so it would appear inevitable that each new generation of citizens will inherit the debt incurred by prior generations (Buchheit et al. 2007). In other words, there is a strong default rule in favor of the continuity of debt despite changes in the state and its territory. No one, for example, doubts that the UK would remain liable for its debts even if Scotland had voted for independence in 2014.

This default rule is very much the product of political and economic considerations. Nevertheless, law and legal actors play a mediating role. Consider the famous *Tinoco* arbitration between Great Britain and Costa Rica in 1923. Before leaving office and the country, Federico Tinoco took a loan from the Royal Bank of Canada, and he absconded with the funds. The question was whether Costa Rica had to repay. The arbitrator—former US President William Howard Taft—ruled that it did not. In the process, however, Taft confirmed that under general principles of international law, government succession does not affect a state's obligations. Costa Rica won not because political transition disrupts the continuity of debt, but because the lender knew the funds were intended for President Tinoco's personal use (Great Britain v. Costa Rica, 1 RIAA 375 (1923)).

The *Tinoco* arbitration is a key historical example underlying the doctrine of odious debt (Feibelman 2007), which recognizes that sovereigns should be allowed to repudiate certain obligations incurred by illegitimate former political leaders. The doctrine has been the subject of much academic attention (e.g., Bolton and Skeel 2007, Stephan 2007, Gelpern 2007) but has made little headway as a rule of law. Nor have sovereigns made much headway in arguing that territorial or political transitions disrupt the continuity of debt. For example, after Montenegro declared independence from the State Union of Serbia and Montenegro, the Republic of Serbia claimed not to be bound by an arbitration clause in a contract entered by the former State Union. The argument was unsuccessful, and the arbitrator entered an award in the creditor's favor, which was subsequently upheld by the English courts (Republic of Serbia v. ImageSat International NV, [2009] EWHC (Comm) 2853, [3] (Eng.)). In a less recent example, a US federal court rejected the argument that Soviet Russia was a successor state not liable for the debt incurred in 1917 by the Provisional Government of Russia (United States v. National City Bank of New York, 90 F. Supp. 448 (S.D.N.Y. 1950)).

Despite these unsuccessful challenges to the continuity of debt, the law in this area is far from clear. For example, even if a state's obligations survive changes to its territory, no clear rules determine how to allocate debt among the state's former regions. A variety of methods have been used, including allocation based on population, GDP, some combination thereof, or even full acceptance of the prior obligations by the biggest successor region (Oosterlink 2013). But these result from ex post negotiation, often requiring years of haggling. When Scotland considered declaring independence from the UK in 2014, no one knew what share of the national debt an independent Scotland would assume (or what share of the North Sea oil it would receive, etc.). Nor was it clear whether creditors would have full claims against both the United Kingdom (now minus Scotland) and the "new" Scotland, against one of the states, or against neither state. Perhaps the uncertainty swayed at least some voters in the direction of the status quo. International law could provide greater ex ante clarity in such contexts, but has chosen not to do so.

Identifying an optimal set of rules would be a daunting task. This is particularly true in contexts involving territorial change, including cases of annexation and territorial secession. Such changes arise under a variety of circumstances, including voluntary and consensual transitions, forcible annexation (Russia and Crimea, circa 2014, perhaps), and "remedial secession" (where a territory exits a sovereign relationship because of oppression (Buchheit 1978)). Our point, however, is not that it would be easy to identify optimal rules for cases involving changes to state territory. Instead, it is that the law makes little effort to supply them. The choice *not* to have rules addressing these questions effectively allocates primary authority to political actors, and we do not envision any sudden re-allocation of this authority. But one can imagine a gradual devolution in which legal actors play increasingly prominent roles.

What would such a transition look like? Above, we noted that direct challenges to the presumption of debt continuity rarely succeed. After all, what is the alternative? One can imagine a world in which sovereigns routinely escaped their obligations following political or territorial change, but the world would have little to recommend it. (Presumably, short-term borrowing at higher rates would be the norm.) Nevertheless, it *is* easy to imagine small changes to existing legal doctrine that would, at the margin, impact a sovereign's ability to obtain debt relief. For example, in the context of so-called odious debt, a number of existing legal doctrines could easily be adapted for use in connection with sovereign loans. These include straightforward principles of agency law, which sometimes place on third-party creditors the burden of making sure that a purported agent—here, the government officials responsible for incurring a loan—are not engaged in self-dealing (Buchheit et al. 2007). As we discuss in the next section, changes to sovereign immunity law might also affect the availability of debt relief.

5. The changing terrain of sovereign immunity

One of the cornerstones of the sovereign debt literature is that sovereigns enjoy immunity from suit and from having assets seized to satisfy a creditor's judgment. As we have noted, the law has gradually changed from the rule of absolute immunity to the so-called restrictive theory of immunity, under which sovereigns can be sued for commercial but not for governmental acts. The literature is familiar with this shift (e.g., Panizza et al. 2009), but seems to overlook its most important, and still-evolving, feature. That feature is that the rules of sovereign immunity are defaults. The primary rule of immunity is that the parties set the rules.

The literature acknowledges that the sovereign can waive immunity, but primarily focuses on the sovereign's ability to waive its immunity from suit (e.g., Panizza et al. 2009, p. 3-4). But immunity from suit is less relevant today, because the modern default rule is that sovereigns are *not* immune from suits arising from lending activity. For example, under US law sovereigns can be sued for their commercial activities carried on in the United States (28 U.S.C. § 1605), and the issuance of bonds is a commercial activity (Republic of Argentina v. Weltover, 504 U.S. 607 (1992)). The more important question is this: To what extent can the sovereign waive its immunity from execution (i.e., asset seizure).

Consider the following two sovereign immunity waivers, which appear in bonds issued by Estonia and Hungary, respectively. The italics is ours and emphasizes a potentially critical difference:

> The Issuer hereby irrevocably and unconditionally waives and agrees not to raise . . . any right to claim sovereign, diplomatic or other immunity from jurisdiction or execution and any similar defence, and irrevocably and unconditionally consents to the giving of any relief or the issue of any process, *including, without limitation, the making, enforcement or execution against any property whatsoever (irrespective of its use or intended use)* . . . . (Republic of Estonia, Offering Circular for 5% Notes due 2007, at 9.)

> To the extent that the Republic may in any jurisdiction claim for itself or its assets or its revenues immunity from suit, execution, attachment . . . the Republic agrees not to claim and irrevocably waives such immunity to the fullest extent permitted by the laws of such jurisdiction, provided that the *Republic does not waive any immunity with respect to: (i) present or future "premises of the mission" as defined in the Vienna Convention on Diplomatic Relations signed in 1961, (ii) "consular premises" as defined in the Vienna Convention on Consular Relations signed in 1963, (iii) any other property or assets used solely for official state purposes in the Republic of Hungary or elsewhere, or (iv) military property or assets of the Republic of Hungary related thereto.* (Republic of Hungary, Offering Circular for 4.5% Notes due 2013, p. 11).

As we have explained, if legal enforcement matters in the sovereign debt context, it is because creditors can use court judgments to impose an embargo on the sovereign's foreign commercial activities. In theory, however, the embargo need not end at commerce. Consider the waiver in the Estonian bond, which quite plainly seems to allow seizure of diplomatic, consular, and military property. It is easy to imagine that a creditor might try to seize such assets; many have already tried.[4] By contrast, the Hungarian bond exempts property used for diplomatic, consular, and military property from its waiver of immunity. These are starkly different immunity waivers. If such waivers are enforced, creditors have the ability to contract, ex ante, for drastically enhanced enforcement rights (Weidemaier 2009).

At present, it is doubtful that waivers of diplomatic, consular, and military property will be enforced. Thus far, courts have taken pains to avoid such questions. In a recent case, for example, a French court ruled that a sovereign must explicitly waive immunity with respect to its diplomatic assets (e.g., *Société NML Capital Ltd v. République Argentine*, Cour de Cassation (1ère Chambre Civile), No. 09-72.057 (Sept. 28, 2011)). Such a ruling would interpret the Estonian bond quoted above to preserve the country's immunity for diplomatic assets. As another example, US law allows creditors to seize only assets "used for a commercial activity in the United States," apparently notwithstanding the scope of any waiver of sovereign immunity (28 U.S.C. 1610). International treaties also may play a role in limiting creditor enforcement rights (Vienna Convention on Diplomatic Relations art. 22, *done* Apr. 18, 1961, 23 U.S.T 3227, 500 U.N.T.S. 95).

We do not expect that sovereign borrowers will routinely agree to the broadest possible immunity waiver. Nor do we claim that courts will (or should) soon allow the routine seizure of, say, military assets. The important point is that legal rules and legal actors determine the scope of the embargo that results from creditor enforcement. Those rules have gradually relaxed in favor of exposing a greater range of sovereign assets to seizure. And the law continues to evolve. So much is clear from the fact that creditors continue efforts to seize sensitive, non-commercial assets. Indeed, the United Nations Convention on Jurisdictional Immunities of States and their Property (not yet in force but often taken as an indication of international law on the subject) appears to recognize express waivers of immunity with respect to non-commercial assets (see Articles 19 and 21). Over the past fifty years, creditors have gradually demanded ever-broader waivers of sovereign immunity (Weidemaier 2014, Choi et al., 2012). If this trend continues, courts and other legal actors will have to decide how seriously to take the idea that sovereign immunity is simply a default.

6. Concluding remarks

Our goal in this paper has been to persuade the reader that the law plays an important if often unappreciated role in sovereign debt. As we noted in the introduction, the academic literature has slowly begun to take this possibility seriously. The most notable exception is the literature on sovereign restructuring, which, broadly speaking, divides into two camps. The first advocates for a public-law system in which sovereign restructuring takes place within a formal institutional framework analogous to bankruptcy. The second, from public-law skeptics, argues that private contracts can provide most

[4] For example, creditors attempted to seize an Argentine naval vessel, and initially succeeded (*ARA Libertad Case* (Argentina v. Ghana), International Tribunal for the Law of the Sea Case No. 20, Order on request for the prescription of provisional measures (15 Dec. 2012). Creditors have also sought to enforce judgments against diplomatic assets (*Société NML Capital Ltd v. République Argentine*, Cour de Cassation (1ère Chambre Civile), No. 09-72.057 (Sept. 28, 2011).

of the benefits of bankruptcy, without such drastic interference by public actors. Both positions, however, take for granted that legal institutions not only matter, but can improve global welfare.

Yet the law is not simply a tool that can facilitate efficient debt restructuring. Legal rules and institutions act as gatekeepers, determining which entities merit the status of "sovereign" borrower. They deploy legal fictions, such as the fiction that the sovereign and its state-owned enterprises are independent legal persons, to limit (or expand) the relevance of legal enforcement. And they can shape some of the most fundamental assumptions about sovereign debt, such as the assumption that sovereign debt persists despite changes in the government or territory of the sovereign borrower. We do not think the presumption of debt continuity is likely to be discarded. Nevertheless, we conclude this section by noting that the law's role in not static.

The presumption of debt continuity, like other legal rules, reflects a broader political, economic, and social context. And that context is evolving. As just one example, compared to earlier eras of sovereign lending, the modern era is characterized by substantially lower barriers to migration. Inevitably, this will exacerbate the inter-generational tension inherent in sovereign debt. Consider the contemporary cases of Iceland, Greece, and Puerto Rico. Over time, their respective governments have incurred massive liabilities. In at least two of these cases, even significant internal reforms probably cannot adequately reduce the debt burden. Nor is it likely that population growth will solve the problem. To the contrary, low barriers to migration mean that population outflows may exacerbate the problem. There is no rule of law that allows a country to escape its debt burdens simply because its population is no longer adequate to service its debt. Indeed, we use these three borrowers as examples only, to highlight a dynamic that will surely become more common. The broader point is that, if one views the law (sensibly) as a dynamic and evolving system, developments like this will surely produce changes in the legal infrastructure underlying the market for sovereign debt.

What might such changes look like? We can imagine a number of possibilities. For example, courts might gradually become more receptive to the argument that citizens should not be responsible for repaying arguably-illegitimate debts. As noted, this is the traditional domain of the doctrine of odious debt, which has not gained much traction as a rule of law. But we do not necessarily envision the wholesale embrace of the doctrine of odious debt. Instead, courts might adapt existing legal doctrines to provide narrow relief, especially in cases involving collusion or other improprieties between the borrower's former political leadership and its lenders (Buchheit et al. 2007). A less provocative approach might involve limiting the extent to which national courts will help creditors enforce arguably-illegitimate sovereign debt.[5] Ongoing litigation in the US demonstrates that courts will sometimes make extraordinary relief available against "uniquely recalcitrant" debtors—in this case, Argentina (Weidemaier and Gelpern 2014). That coin has two sides. In a case where the legitimacy of the loan itself is in question, courts could aid the borrower simply by refusing to grant potent, discretionary remedies.[6] If Ukraine defaults on loans owed to Russia, perhaps we will see an early test case for such theories (Blocher and Gulati 2015).

Conversely, the law may enhance creditor enforcement rights when the legitimacy of the loan is not in question. Two avenues for change seem especially likely. First, "veil piercing" rules might be more liberally applied, so that creditors of a sovereign could more easily enforce claims against the

[5] Gelpern (2014) makes a similar proposal for debt owed by Ukraine to Russia.
[6] In particular, courts might deny the kind of injunctive relief awarded against Argentina, which limits the country's ability to service its restructured debt.

assets of state-owned and state-controlled enterprises. Second, the law might enforce increasingly expansive waivers of execution immunity. These developments would dramatically enhance the potency of legal enforcement and, in the process, undermine the categorical divide drawn in the literature between sovereign and private borrowers.

These are, of course, just guesses as to what the future might hold. The fundamental point is much simpler: The law of sovereign debt is the product of broader social, political, and economic forces that are familiar to students of the field. How these forces influence the law going forward is itself a worthy topic of study.

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