D4 - Sovereign Debt Crisis Management

Why Creditor Litigation is Important

In a typical litigation scenario, a "vulture creditor" buys sovereign debt claims prior to a debt relief or debt restructuring agreement at a deep discount (e.g. for 10% of the nominal value) with the explicit intention to sue debtor governments for full debt repayment, i.e. for 100% of the nominal value plus accumulated interest. Most lawsuits related to international debt contracts are filed either in New York courts or London courts, although, increasingly, lawsuits are being initiated in other creditor countries such as Germany, Italy or Switzerland or even in domestic courts of debtor countries, e.g. after the Russian debt crisis of 1998 (see Sturzenegger/Zettelmeyer 2007a or Szodruch 2008 for a detailed description of the process of creditor litigation against sovereigns).

Cross-border litigation and the related enforcement of claims towards sovereign debtors is genuinely cumbersome. The enforcement of creditor rights is limited for two main reasons. First, there is no such thing as a standardized bankruptcy regime for sovereigns, comparable to chapter 11 for US corporations or the German Insolvenzrecht. Sovereign debt is typically not backed by any collateral and only few attachable government assets are located outside national borders[1]. Second, legal principles such as *sovereign immunity*, the *act of state doctrine* or the *principle of international comity* protect sovereign assets even when they are located in foreign jurisdictions. While we refer to Sturzenegger and Zettelmeyer (2006, 2007a) for details, it is important to underline that due to statutory changes and case law development, these legal principles have been weakened since the 1950s, thus strengthening creditor rights and allowing for more litigation against sovereigns (see also Fisch/Gentile 2004 or Szodruch 2008 for historical accounts). The change in legal doctrine has been an important precondition behind the increasing number of litigation cases in the last three decades and the emergence of a "vulture creditor industry", those specialized investment funds that have learned to make a profit from suing sovereigns.

With more and more cases filed against sovereigns, litigation and related holdouts by creditors are frequently blamed as an increasingly problematic obstacle for the resolution of sovereign debt crises in emerging market economies (Goldman 2000; IMF 2003; Krueger 2002; Rogoff/Zettelmeyer 2002; Shleifer 2003). Moreover, the rise of "vulture creditors" is regarded

[1] Creditors have in the past attempted to seize all types of assets of foreign governments, ranging from deposits of government owned companies in foreign bank accounts to non-liquid assets such as fighter planes or even art exhibits (see e.g. Pitchford/Wright 2008).

as a key concern for the various initiatives of debt relief in the poorest countries in the world. "Vulture funds", or "distressed funds" as they prefer to be called, have had increasing success in suing developing countries in courts in recent years.

Research Objectives

The project aims at providing the first systematic and comprehensive empirical analysis on the causes and consequences of litigation between commercial creditors and sovereign governments of developing and emerging market economies. A cornerstone of the project will be the construction of a large novel dataset on litigation cases against governments of poor and middle income countries for the period 1980 to 2008. This will allow analyzing the issue in a systematic way.

Based on our newly constructed database and the data already assembled in the "Sovereign Default Archive" between 2006 and 2009, the project will then investigate the following two *core research questions:*

1. What are the political and institutional determinants of creditor litigation? In particular, are weak and poor states more vulnerable to legal action by "vulture creditors", as compared to stronger states? Moreover, are democratic regimes more vulnerable to litigation, since they are more inclined towards "aggressive default"?[2]

2. What is the impact of litigation on public debt management and thus the government's ultimate capacity to provide public goods and poverty alleviation services? This involves an analysis on how large the direct and indirect effects to a government's public finances are (direct costs, scope of debt relief) and to what extent litigation delays debt restructuring and debt relief efforts.

Table 1 summarises the research design which results from the research questions. Stage 1 will mainly try to find evidence on the determinants of lititgation events, while the second stage will go one step further in addressing consequences of legal conflicts with private creditors.

Table 1: Research Design

	Dependent Variable	**Key Explanatory Variable**	**Control Variables (Intervening)**
Stage 1	Litigation Events	Degree of Statehood (Strong vs. Weak)	Creditor Structure, Official Aid and Debt Relief, Legal Context
Stage 2	Government Finances/Debt Management (Capacity to Provide Public Goods)	Litigation	Degree of Statehood, Official Aid and Debt Relief, Legal Context

Stage 1: Assessing Determinants of Creditor Litigation

The relevance of the a priori main explanatory variables will be analyzed in part 1 of the project. Above all, debtor characteristics are likely to play a crucial role. It is notable that

[2] cf. the results of project phase 1.

poor countries with weak state capacity have been subject to a particularly large number of lawsuits by creditors and "vulture funds" in recent years. The World Bank and the International Monetary Fund (2006), for example, report forty-seven court cases against a total of eleven highly indebted poor countries in the last 10 years alone. This is surprising to a degree, as the volume and relative share of debt owed to commercial creditors in restructurings with HIPCs is much smaller compared to other recent restructuring cases of middle income countries that did not feature any litigation (e.g. in Uruguay 2003 or the Dominican Republic 2005). Facing a large number of "attacks" relative to the amount of debt outstanding, HIPCs may also lack the expertise and funds to appropriately react to lawsuits by private actors in international courts. It is revealing in this regard that the World Bank and the IMF, as well as the African Development Bank, worried by the vulnerability of these countries vis--vis litigious creditors, are all considering the establishment of a specialized fund to finance legal assistance to HIPCs (IMF/World Bank 2003, 2007). Similarly, the Commonwealth Secretariat has already set up a "Legal Debt Clinic" for HIPCs in order to raise awareness on the risks and implications of litigation.

As to middle income countries, some countries in default have been subject to litigation while others have not. No systematic analysis has yet explained this heterogeneity. It is noteworthy, however, that "aggressive defaulters" as classified by Enderlein et al. (2007), i.e. countries that refuse to negotiate and cooperate with their commercial creditors in default situations, have been subject to a particularly large number of lawsuits in recent years. Most prominently, this is the case in Argentina, which is among the best known cases of non-cooperative default behavior (between 2001 and 2003 over one hundred lawsuits were launched against Argentina alone, see Gelpern 2005), but also for cases such as Russia (1991-1995 and 1998-2000), Peru (1985-1997) and, most recently the unilateral default of Ecuador in December of 2008, which is widely expected to trigger a "rush to the courthouse[3]". Governments, who restructured their debt quickly and in agreement with creditors, have been subject to less litigation (e.g. the restructurings in the Dominican Republic 2005, Belize 2007, Pakistan 1999 or Uruguay 2003).

Obviously, other factors may also play a decisive role for the occurrence and outcome of litigation cases and will thus have to be taken into account carefully in the quantitative and qualitative analyses. This is particular true for legal aspects such as changes in the legal doctrine and the legal characteristics of sovereign debt contracts. More specifically, the main determinants of creditor litigation to be analyzed can be structured as follows:

Characteristics of Debtor Countries

1. *State capacity:* The "quality of government" (La Porta et al. 1999) and of its bureaucracy is likely to be a key explanation for number of lawsuits filed and the success of these cases.

2. *Legal Origin and Legal Context:* The legal origin of a country will influence the decision under which governing laws (e.g. English law or New York law) governments place their international debt[4].

[3]The newly created "Ecuador Bondholders Group" is currently appealing to all bondholders to resort to legal action against the government. http://ecuadordefault.com/home/ (14.02.2009)

[4]Most international bonds of developing countries governments have been issued under New York or London

3. *Government coerciveness in crisis resolution:* More aggressive crisis resolution policies (as measured by Enderlein et al. 2007) are expected to trigger more opposition by creditors, thus invoking litigation and lawsuits.

Structure of creditors and debt markets

4. *The type of creditors involved:* It can be assumed that banks are less likely to file a claim than individual bondholders or investment funds, since they typically have a more explicit interest in good country relations and reputation (Eichengreen 2000; Goldman 2000).

5. *Origin of creditors:* It is reasonable to assume that creditors from non-Western countries are more likely to sue developing country sovereigns. The reason is the potential for moral suasion and pressure on litigious creditors by Western country governments interested in a successful outcome of debt relief efforts.

6. *The development of secondary bond markets:* A liquid secondary market can be expected to facilitate the enforcement of sovereign debt via legal means (Broner et al. 2006; Power 1995).

Further Key Control Variables

7. *Legal characteristics of bond and loan contracts:* The legal characteristics of the sovereign loans and bonds will obviously be crucial for the occurrence and success of litigation.

8. *Role of Bilateral Donors and Multilateral Organizations:* The effect of third party involvement by donor governments or International Financial Institutions (IFIs) for litigation occurrence is not straightforward, as several channels may be at work. In principle, litigation may be less likely if debtor countries closely cooperate with multilateral organization such as the IMF and the World Bank, as these may assist in protecting against lawsuits. On the other hand, litigation risks may increase with the prospect of generous official debt relief.

9. *Role of NGOs and Public Relations:* The watchdog function of NGOs and the press are likely to lessen the risk of litigation to a certain degree. Prominent policy fora such as Jubilee, erlassjahr.de and others may prevent banks and investment funds to embark in litigation, as they may fear negative press coverage and pressure by these civil society actors.

Stage 2: Assessing Consequences of Creditor Litigation

In part two of the project, the focus will shift on the consequences of litigation events. As a natural starting point, the project will collect all available data on the direct financial losses related to litigation and estimate the scope of its indirect financial costs. The aim is to assess -

law, although there have also been issuances under Luxembourg law, German law, and more recently, Japanese and Italian law (Sturzenegger/Zettelmeyer 2006).

as exactly as possible - in how far the fiscal capacity of governments is constrained by litigation, thereby affecting its key governance functions and public good provision. Furthermore, the project will analyze additional negative side-effects of litigation, in particular delays in implementing debt restructurings and debt relief agreements as well as immediate side effect such as the cancelation of public investment projects.

1. *Direct Financial Costs ⇒ Litigated Claims*

   The direct costs of litigation to debtor governments, i.e. amounts to be paid to creditors winning a lawsuit, can be quite considerable.

2. *Indirect Financial Costs ⇒ Less Debt Relief by Commercial Creditors*

   Litigation is an important fallback option for creditors and has often been used as a strategic "weapon" in debt renegotiation talks. Accordingly, restructurings involving creditor litigation may result in a less favorable negotiation outcome for the debtor government. It is thus reasonable to expect that litigation can lead to a smaller scope of debt relief granted by commercial creditors or, in other words, to smaller implied losses for private creditors.

3. *Side Effects ⇒ Delays in Implementing Debt Restructurings, Budget Cuts or the Cancelation of Investment Projects*

   Besides financial losses, litigation may have additional negative side effects. One side effect may be troublesome delays in the implementation of debt restructuring and debt relief agreements.

Methodolgy

In its first stage, the project will use statistical analysis and qualitative process-tracing to explain the determinants and the context of litigation between private creditors and sovereign debtors, focusing on the role of state capacity. Stage two will then involve empirical analysis with the aim to quantify the costs and adverse consequences of litigation for poor and middle income countries in the developing world. Extensive qualitative process-tracing on four selected case studies will be mainly applied in stage one with the aim to understand the context and driving factors of litigation in detail. However, qualitative analysis will also be applied in stage two in order to gain some insights on the immediate consequences and side effects of litigation.

The sample of cases will be based on the overall sample of developing countries in the broad definition (World Bank, Global Development Indicators), explicitly including cases of countries that would today be classified as 'Heavily Indebted Poor Countries' (HIPCs), i.e. countries that face an unsustainable debt situation and that are classified as the poorest countries. It is reasonable to assume a high correlation between fulfilling the HIPC criteria and fulfilling the criteria of "limited statehood". We aim to code and analyze the entire universe of litigation cases since 1980 (probably around 300 cases, or more).

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