

12-1-2016

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Recommended Citation

Odette Lienau, "Embedded Contracts and a Continuum of Sovereign Debt," 6 *Accounting, Economics, and Law* 263-272 (2016)

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Embedded Contracts and a Continuum of Sovereign Debt

DOI 10.1515/ael-2016-0068

Published online December 17, 2016

Abstract: What is the relationship of a government to its population as it pertains to sovereign debt? And how does this fit into the larger web of relationships and obligations that make up the international financial arena? These questions are incredibly difficult to think through – beyond the capacity of one author alone. I am therefore grateful to have the company of Yuri Biondi, Barry Herman, Tomoko Ishikawa, and Kunibert Raffer in beginning to consider them. In addressing their thoughtful and thought-provoking comments, I see this response less as an opportunity to answer every potential challenge or differential emphasis. Indeed, the comments by and large extend the analysis of the book in incredibly insightful ways. Instead, I take this brief essay as a chance to identify several themes uniting the responses, and to highlight how these themes raise additional questions for the sovereign debt regime going forward. In particular, the comments suggest the ways in which the issues and actions associated with questions of sovereign legitimacy in the debt market exist not as dichotomies but rather on a continuum. I fully agree with this implicit characterization, and contend that – given that this is the case – challenging the market narrative that supports the repayment of odious debt should help to undermine resistance to reforming the regime for restructuring sovereign debt more generally. In addition, the comments emphasize how sovereign debt can be thought of as embedded in two types of social contract, both of which should shape how we think of appropriate policy responses to the challenges of the contemporary moment.

Keywords: sovereign debt, creditworthiness, sovereign debt restructuring, sovereignty, odious debt, debt sustainability, international law, global governance

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1 Introduction

What is the relationship of a government to its population as it pertains to sovereign debt? And how does this fit into the larger web of relationships and obligations that make up the international financial arena? These questions are incredibly difficult to think through – beyond the capacity of one author alone. I am therefore grateful to have the company of Yuri Biondi, Barry Herman, Tomoko Ishikawa, and Kunibert Raffer in considering them. In addressing their thoughtful and thought-provoking comments to my book, *Rethinking Sovereign Debt: Politics, Reputation, and Legitimacy in Modern Finance*, I see this response less as an opportunity to answer every potential challenge or differential emphasis. Indeed, the comments by and large extend the analysis of the book in incredibly insightful ways. Instead, I take this brief essay as a chance to identify key themes uniting the responses, and to highlight how these themes raise additional questions for the sovereign debt regime going forward.

2 A continuum in sovereign debt and market resistance

In *Rethinking Sovereign Debt*, I focus particularly on the norm of debt continuity: the assumption that sovereign debt must be repaid – even after a major regime

change – in order to maintain country creditworthiness. I argue that this norm is not a given, but rather is shaped by broader ideational and institutional structures that have shifted over time, and suggest that the treatment of odious debt-type arguments after major regime change offers insight into the strength of the debt continuity norm at any given moment. This focus has meant that, in both the overarching narrative and in particular case studies, I have tended to emphasize the outer edge of sovereign debt, where issues of significant regime change and possible repudiation may be relevant.

Of course, my goal is hardly to limit the analytical framework to these outer edges. Still, the symposium participants to various degrees have rightly challenged me to take the applicability of my analysis deeper into the mainstream of sovereign debt, making more concrete the broader potential suggested in the book. I welcome this suggestion and appreciate how the symposium essays ask questions and indicate steps in this direction. In particular, the comments highlight the ways in which the issues and actions associated with questions of sovereign legitimacy in the debt market exist not as dichotomies but rather on a continuum. I fully agree with this implicit characterization, and suggest that – given that this is the case – challenging the market narrative that supports the repayment of odious debt should help to undermine resistance to reforming the regime for restructuring sovereign debt more generally.

As noted in the symposium introduction, the book's case studies and historical analyses seek to understand the norm of debt continuity in part by pointing out shifts between more and less "statist" understandings of sovereignty in sovereign debt. Only a pure statist understanding of sovereignty – in which effective control of a state's population and territory is sufficient to count as legitimately "sovereign" – can support a strict expectation of continuity, in which all debt should in principle be repaid after a regime change regardless of the debt's problematic provenance. And I suggest that the acceptance of a statist versus a non-statist approach at any given historical moment can be seen through arguments about odious debt, in which a new regime may seek to repudiate on the basis of political principle. I intend this somewhat dichotomous framing – statist/non-statist and repudiation/repayment – to be an ideal type, meant to guide the selection of cases and provide a common vocabulary for discussing these themes. Indeed, a number of the book's examples demonstrate how this theoretical dichotomy looks far more complex in practice. However, several commentators still – and fairly – highlight the ways in which much sovereign debt escapes this dichotomy even beyond the ways I suggest.

Kunibert Raffer extends the book's themes and arguments in incredibly helpful ways, particularly by highlighting how a number of nineteenth century cases corroborate the argument that the pre-World War II era demonstrated a

more flexible – and at least in certain moments even a more rational – approach to sovereign debt. A number of these cases demonstrate an openness to arguments about non-statist political legitimacy, a central theme in my book. The historical actors in other cases, however, display rationality simply by addressing – in a relatively straightforward, efficient, and cooperative manner – the economic need for a substantial debt write-down. These write-downs, which Raffer points out are eventually inevitable in many sovereign debt crises, could provide a model for how more restructurings should go. However, they seem to leave out the questions of political legitimacy and sovereign action central to my book. Raffer thus points out that, “all historical cases of sovereign debt overhang prove that debts must eventually be reduced by substantial amounts,” and suggests that this fact “reduces the practical relevance of the dichotomy statist-non-statist considerably” (Raffer, p. 15).

Similarly, Barry Herman suggests a possible broadening of the argument’s ramifications beyond a traditional odious debt analysis, wondering if the repudiation/repayment and odious/legitimate dyads are especially helpful in most instances. Speaking of early civil society attempts to advocate for odious debt ideas, he suggests that these discussions have abated somewhat “because the argument did not advance advocacy for sustainable debt” (Herman, p. 15). Tomoko Ishikawa also recommends an extension of the discussions of odiousness to include a focus on “illegitimate debt” more generally, which would be relevant in a broader range of cases and regardless of the presence of a regime change (Ishikawa, p. 17, 21).

In a similar vein, Yuri Biondi notes that the book and its cases tend to focus on the initial and final potential phases of sovereign debt – when the debt is first issued and when it is ultimately repudiated (or restructured or repaid). But he points out that the debtor is in fact a “going concern,” with a full-bodied financial life between these two phases; in the contemporary era of sovereign bondholding, much is happening during the middle phase of debt service (Biondi, p. 2 et seq.). In particular, the presence of liquid financial markets for sovereign bonds means that the initial creditor is likely to sell the relevant sovereign debt holdings on the market – a process that may happen many times – before a sovereign state ultimately decides on its final disposition of the debt. This means that the original lender is not necessarily going to be in the picture if the debtor state ultimately finds the loans problematic and things fall apart.¹ Under this more fluid situation, Biondi asks “can lending investors be

¹ Herman makes a similar point: “From the bondholder’s perspective, the bonds are purely financial instruments that are included for a time in the investor’s portfolio. There is probably little thought given to the ethical nature of the government that issued the bond or how the

excused from considering their counterparty's situation when default occurs?" (Biondi, p. 4).

Broadly speaking, these comments throw into question the ideal type framing and case selection of the book, inviting and suggesting applications more relevant to the majority of debt restructuring cases today. But this hardly means that the book's animating questions of interconnectedness, social obligation, and political legitimacy are absent in the more everyday workings of sovereign debt; indeed, I do not believe the commentators think this is remotely the case. Instead, the essays highlight for me the way in which sovereign debt should be understood as on a continuum. One end of the continuum of illegitimacy, for example, might involve a loan contracted by a government oppressively installed, with proceeds used for tyrannical or corrupt purposes, the payment of which would constitute a real hardship for the country in various ways. A variation on this might involve a loan with a problematic provenance, but which would *not* constitute a burden in its repayment. Also on the continuum could be debt that is relatively *unproblematic* in its provenance or use, contracted by a universally acceptable and longstanding regime, the payment of which would nonetheless impose an unsustainable burden. Accepting the problematic nature of one type of debt hardly denies the importance of dealing with another, from both an economic and an explicitly moral perspective. A rational and fair sovereign finance regime would deal with a range of debt problems. And the current background rule insisting on 100% payment in all cases – with any deviation hard fought and marked as “forgiveness” – undermines, in my view, such rationality and fairness.

Still, how might undermining the narrative of market necessity that supports debt continuity in potential odious debt cases connect to other types of debt problems, including that of debt sustainability? In both cases, the responsibility of lenders in causing or exacerbating a sovereign debt crisis is often diminished, with accusatory eyes fixed exclusively on the borrower. But there are still

funds were used one, five, or ten years earlier when they were actually borrowed.” Herman, p. 5. (Of course, this indifference is what many analysts of sovereign debt hope to change.) In legal terminology, we could ask about the degree to which there is still “privity of contract” – i. e. are the two counterparties bound by the same contractual rules or has the chain of contract assignment gone so far that certain duties and defenses are no longer relevant? Setting aside questions of technical legal doctrine here, which will of course vary across jurisdictions, the underlying question is the degree to which there is a sufficient connection between the two counterparties to justify a heightened degree of attentiveness to and obligation for the other's situation.

distinctions made across borrowers. In particular, there can be – rightly or wrongly – more sympathy and moral outrage for a new regime struggling under the potentially odious debt contracted by a former ruler than for a debtor dealing “merely” with unsustainability; in the debt sustainability case, there are more likely to be charges of irresponsibility, borrower profligacy, and so on. But what is interesting to me is that in *both* cases – *even* in the sympathetic odious debt case – the background rule of repayment stands strong; it remains a bulwark across the continuum of debt cases, and a continuous wall against significant reform of the debt restructuring regime. As I noted but did not have a chance to elaborate upon in the book:

Although the repayment norm is most starkly applied in situations of regime change and transitional justice, its expectations filter into the prospects and bargaining positions of debt negotiations more generally. If repayment is expected *even* in such extreme circumstances, then debtors should *certainly* bear the burden in other situations that might emerge. By policing the boundaries of the sovereign debt regime – and ensuring that such issues remain marginal – this rule keeps the core flow of capital safe and relatively free of controversy.²

Just as there is there is a continuum of sovereign debt cases, each of which implicates different but overlapping questions of political legitimacy and economic rationality, so too is there a continuum in the market narrative that insists on a full repayment rule for each of those cases. My hope is that undermining the narrative of market necessity for the odious debt case will help to throw into question the market narrative standing as a bulwark against sovereign debt reform more generally.

3 Embedded social contracts in international finance

Imagine that we do begin to break down the wall of assumptions protecting the contemporary debt regime – the assumptions that the dominant rules are politically “neutral,” that the reputational mechanism supporting sovereign finance could not encompass alternative notions of fairness and rationality, and that all creditors will inevitably act in the same way. If there were greater

² Odette Lienau, *Rethinking Sovereign Debt: Politics, Reputation, and Legitimacy in Modern Finance* (2014), p. 2.

flexibility in reforming sovereign debt processes, how should we conceive of interconnectedness, social obligation, and political legitimacy across the full spectrum of restructuring cases? The symposium comments' engagement with a broader range of debt situations emphasizes to me how sovereign debt can be thought of as embedded in two types of social contract, both of which should shape how we think of appropriate policy responses to the challenges of the contemporary regime.

In *Rethinking Sovereign Debt*, I highlight the centrality of one type of relationship to sovereign debt – the relationship between the government entering into the debt obligation and the population against which that obligation ultimately will be enforced. This relationship can be characterized as a kind of social contract in the most general sense, although in some governmental structures it may be an appallingly lopsided contract in terms of benefit and control. This intra-governmental social relationship is in turn necessarily at the center of every sovereign debt contract; without the implicit acknowledgment and assessment of this relationship in some way, there would be no basis for enforcing debt once a particular government (or even a particular presidential or parliamentary administration) has changed.³

This requirement of external acknowledgement points to yet another relationship essential for sovereign debt – that between the broader international community on the one hand and the state government and population on the other. Indeed, it is this larger global relationship that the symposium contributors have pushed me to consider more fully in various ways. Certainly, without the existence of the sovereign state, including its institutional capacity to borrow in the name of a collective and to extract funds from that collective, these markets could not arise. This is clearly the situation in the initial borrowing and in the repayment, and Biondi emphasizes how this is the case even through trading on liquid secondary markets. Such trading often relates to refinancing activities associated with central banking and monetary management, and are therefore “embedded in this non-market institutional framework” (Biondi, p. 4). Biondi continues, “a mutual relationship between sovereign borrower and its creditors is established and maintained.... This implies that lenders have been functionally involved in the borrower's situation by investing in and trading on sovereign securities” (Biondi, p. 5).

³ Although I characterize this relationship as one of principal and agent, broadly understood, I acknowledge Herman's suggestion that the analogy is not perfect or may need to be modified for longer-term debt contracts. Herman, p. 11.

Although this enmeshing and embeddedness is not generally understood to be part of a broader social contract – certainly not by most investors – perhaps it should be. Indeed, any contract, even an arm’s-length contract, is made possible by the functioning of the larger society. As such, some form of obligation may in turn be owed to that society.⁴ This can be understood as part of the theoretical basis for insolvency or bankruptcy regimes: you live in, participate in, and benefit from this society, including through entering into arm’s-length contracts that are generally supported and enforced. However, if another member of this society suffers and is unable to make good on these contracts, you may have your contract re-written in an unanticipated manner.⁵ Not all countries have actually enacted bankruptcy legislation, although the number of states boasting insolvency frameworks has increased substantially, but the possibility remains in the background, and insolvency laws are considered justified and rational in most quarters.

What is the most general ramification of thinking about sovereign debt as embedded in two social contracts – first, between the government and the people and, second, between this initial dyad and the global community writ large? Most simply, we should consider both layers of potential social obligation when contemplating reforms to the contemporary sovereign debt regime. Of course, when is hardly easy to know the likely fruits of such attentiveness in advance. As I point out in the book, there are many competing ways to conceive of the proper relationship between a government and its population. And there are certainly at least as many ways to think of the proper range of social obligations implicating actors in global society more generally. However, taking this perspective suggests that these difficult questions should be closer to the center of reform discussions. This perspective also helps to bring in and unify a range of insights drawn from the symposium comments.

To begin with, if sovereign debt is embedded in a broader social contract, what should any reform mechanism include? It seems that at least three types of issues should be addressed to deal with the continuum of sovereign debt cases and concerns through this lens. First, it seems reasonable to include an attentiveness to odious debt and principal-agent type questions, which would put sovereign debt on a closer footing to corporate debt in terms of requiring a basic understanding of how the contracting entity (be it a governmental actor or corporate CEO) actually

⁴ Biondi parallels this argument in his discussion of the secondary markets, suggesting that lenders, who have necessarily depended on state institutions, must attend to the underlying social-political situation, “including when default occurs.” Biondi, p. 4.

⁵ Of course this is only one way of thinking through justifications for insolvency laws; the debate on the theoretical basis for bankruptcy in U.S. scholarship, for example, continues apace.

relates to the underlying borrower counterparty (the population or the corporation's shareholders or ultimate residual claimants).⁶ Second, an improvement on the current system would attend to basic questions of human rights, regardless of debt provenance or regime change. Herman's suggestion of a "social floor," below which it is considered unreasonable for a state's population to make sacrifices in favor of debt payment, seems apt in this regard. And finally, relatedly, attentiveness to questions of debt sustainability would be appropriate.

In addition, how might sovereign debt reform be executed? What institutional actors are accountable for thinking about sovereign debt as embedded in dual social contracts? The discussion is hardly exhaustive, but the commentators note multiple institutional players relevant to the debt regime, each of which would be fair targets for consideration. For example, Ishikawa highlights the centrality of courts and court rulings, particularly in creditor countries. She suggests that greater guidance could be offered to adjudicators in order to achieve a more uniform and fair approach, perhaps one that apportions partial liability to debtors and creditors in cases of illegitimate debt. Herman acknowledges the inescapability of reputational mechanisms in incentivizing repayment and promoting capital recycling, and calls for a mechanism for certifying or at least clarifying what would constitute a legitimate as opposed to an illegitimate loan in advance. "The chief point is that non-payment of an uncertified debt should not provoke a general exclusion of the debtor government from the international bond market" (Herman, p.16). Raffer emphasizes the centrality and the occasional hypocrisy of the international financial institutions, suggesting the importance of including them in the discussion but also considering them as targets for policy reform. Raffer also emphasizes how certain expectations or rules in sovereign lending seem to be applied unevenly, particularly across Northern and Southern countries, and thus implicitly advocates for a more evenhanded application of any guiding principles and expectations. And both Herman and Raffer highlight the importance of a general, internationally grounded insolvency framework that could comprehensively address the debt sustainability problems mentioned in the previous section. I would also note that paying attention to the perceived legitimacy of any reformed restructuring mechanism would be important, both as an end in itself and also because it would likely grant that mechanism a greater chance of success.⁷

⁶ For more on this analogy, see Lienau, *Rethinking Sovereign Debt*, pp. 21–24.

⁷ For this argument, and a discussion of features that might make a mechanism more or less legitimate, see Odette Lienau, "The Challenge of Legitimacy in Sovereign Debt Restructuring," *Harvard International Law Journal*, Vol. 57, No. 1 (Winter 2016).

4 Conclusion: opening policy space

Some readers may be frustrated by my approving litany of a whole range of reform possibilities – is there not one that I prefer over others? I hinted earlier that my goal in writing *Rethinking Sovereign Debt* was not so much to advocate for one or another reform approach but rather to open up policy space for thinking about and pursuing these various alternatives. The book attempts to do this by undermining the theoretical foundations of more conventional frameworks, suggesting that the narratives helping to support these approaches are frequently mistaken or oversimplified. In addition, it rejects any notion that the current system is inevitable or unchangeable, providing historical evidence of alternative cases and empirical insight into why one approach or another might dominate.

In its last pages, the book also suggests that incorporating odious debt ideas into the contemporary moment would not *necessarily* require a new international organization, pointing to the capability of market actors to make judgments about political legitimacy when pressed. This does not mean, of course, that greater uniformity, guidance, and institutional structure might not be helpful both for potential odious debt cases and for other situations on the sovereign debt continuum. While I remain concerned (but possibly still convinceable) about an international organization pre-certifying loan contracts or regimes,⁸ I would readily support a range of other options. These include the creation of some kind of international insolvency regime, the national-law limitation of profits gained through certain types of “vulture” financing, the rationalization of existing hybrid public-private restructuring mechanisms, the improvement of sovereign loan contractual clauses, and the establishment or greater adoption of guiding principles on responsible lending and borrowing, such as the 2012 UNCTAD Principles. It is hard for me to select one approach as better – though I do think that market mechanisms alone are unlikely to be sufficient – and moreover I do not believe that this kind of selection is necessary or especially helpful. Given the political difficulty of successfully implementing *any* of these approaches, it seems best to support a range of possible options for negotiators involved in sovereign debt restructuring and reform. Indeed, the active support of all at the same time is likely to be most useful; if history is any indication, pursuit of one reform mechanism tends to put progressive pressure on others as well, with the hope that eventually one or more of these campaigns will bear fruit.

Acknowledgment: I am grateful to Yuri Biondi for comments on this response.

⁸ I discuss this briefly in the final pages of the book. See especially Lienau, *Rethinking Sovereign Debt*, pp. 237–238.