A Skeptic’s Case for Sovereign Bankruptcy

Anna Gelpern
Georgetown University Law Center, ag1348@law.georgetown.edu

This paper can be downloaded free of charge from:
https://scholarship.law.georgetown.edu/facpub/1282
http://ssrn.com/abstract=2198161

50 Hous. L. Rev. 1095-1127 (2013 forthcoming)

This open-access article is brought to you by the Georgetown Law Library. Posted with permission of the author. Follow this and additional works at: https://scholarship.law.georgetown.edu/facpub

Part of the Bankruptcy Law Commons, and the Finance Commons
COMMENTARY

A SKEPTIC’S CASE FOR SOVEREIGN BANKRUPTCY

Anna Gelpern*

TABLE OF CONTENTS

I. INTRODUCTION .......................................................... 1096

II. WHY BANKRUPTCY? .................................................. 1099
   A. Too Much Debt, Wrong Sort of Debt .......................... 1099
   B. Coordination Problems .......................................... 1101
   C. Delay and Taboo .................................................. 1103
   D. Chaos Theories ................................................... 1105
   E. Fragmentation, Selectivity, Discrimination ............... 1106
   F. Overborrowing and Dilution .................................. 1109
   G. Interim Financing ................................................ 1111
   H. Bailouts and Moral Hazard .................................... 1113
   I. Illegitimacy and Capture ....................................... 1114

III. CORE PROBLEMS AND BANKRUPTCY IMPLICATIONS ...... 1116
   A. Unenforceable Debt ............................................. 1116
   B. Nondischargeable Debt ......................................... 1119
   C. Debt Fragmentation ............................................. 1120
   D. Authority and Legitimacy ...................................... 1120
   E. Bankruptcy Implications ...................................... 1122

IV. CONCLUSION: THE FEDERALISM OVERLAY .................. 1124

* American University Washington College of Law and Georgetown University Law Center. I am grateful to the participants in this Houston Law Review symposium and in the Humboldt University conference, A Debt Restructuring Mechanism for European Sovereigns—Do We Need a Legal Procedure?, as well as to the editors of this volume, Kyle Bates, Ryan Farha, and Ellen Ostrow for help with this Commentary.
I. INTRODUCTION

I have had the privilege of talking sovereign bankruptcy with David Skeel for the past decade. One of the first articles I ever published was part-concurrence, part-debate with David Skeel and his coauthor, Patrick Bolton, about priority structures for sovereign debt.\(^1\) Although we all favored priorities, we differed on the content of the optimal priority scheme and ways to achieve it.\(^2\) Bolton and Skeel advocated a uniform treaty-based scheme,\(^3\) and I a debtor-chosen contractual one.\(^4\) In retrospect, our areas of agreement were much more important than the daylight between us: rather than join the policy establishment in pursuit of the holdout creditor, we looked to the legal structures for sovereign debt management, and found them wanting.\(^5\) I am grateful for the opportunity to continue the conversation here.

It is fair to say that since those early days, I have been a sovereign bankruptcy skeptic. Summarized harshly, I have said that bankruptcy for sovereigns was either pointless or meaningless, and in either case, would never happen.\(^6\) After leaving the government for teaching, I learned that the last argument—it would never happen—was beside the point. If I wanted to be a policy pragmatist, I should have stayed behind. Our job here is to challenge imaginations until reality catches up.

On the other hand, the pointless–meaningless conundrum requires elaboration. My concern is with sovereign bankruptcy proposals that either solve nonexistent problems or purport to be all things to all people. I have argued elsewhere that the pointlessness problem comes from lifting the institutional features of one or another chapter in the U.S. Bankruptcy Code—designed to overcome real obstacles in the U.S. cultural, political, legal, and market context—and grafting them onto sovereign debt markets, where the obstacles may not exist and the solutions would not help.\(^7\) Countries have debt problems;

---


\(^2\) Id. at 1145–50; Bolton & Skeel, supra note 1, at 767, 788–93.

\(^3\) Bolton & Skeel, supra note 1, at 818.

\(^4\) Gelpern, supra note 1, at 1118.

\(^5\) See Bolton & Skeel, supra note 1, at 821–22; Gelpern, supra note 1, at 1118, 1138–39.


\(^7\) See Gelpern, supra note 1, at 1122–23.
they do not have the debt restructuring problems of U.S. firms, towns, or individuals.\(^8\)

Meaninglessness comes in response to accusations of pointlessnes. Confronted with evidence that holdout lawsuits have not disrupted sovereign restructurings, that sovereign immunity has been a serviceable shield from creditors, and that facilitating creditor coordination has not stopped bailouts,\(^9\) proponents might shift from an institutionally specific version of bankruptcy to one that is all-encompassing.\(^10\) They evoke something like Elizabeth Warren’s capacious vision of bankruptcy as “an attempt to reckon with a debtor’s multiple defaults and to distribute the consequences among a number of different actors” on the basis of “a number of competing—and sometimes conflicting—values in this distribution.”\(^11\)

Warren was ascribing purpose to an existing regime in a particular setting.\(^12\) She could afford to be general and poetic because she was not designing from scratch, but rather fighting for the soul of an operating system. Sovereign bankruptcy advocates do not have this luxury. A credible proposal must diagnose the most pressing sovereign debt problems it would solve, offer tools to solve such problems, and explain how these tools improve on the status quo.

Given my record of skepticism, it might come as a surprise that this Commentary is an attempt not only to support the general idea of statutory sovereign bankruptcy, but also to imagine some of the features it should have. I engage in this thought experiment for two reasons. First, despite my reservations about transplanting bankruptcy for sovereigns, I like and respect many of the people who propose it, and want to try my best to agree with them. Second, recent debt restructuring experience in Europe and Latin America convinced me that the

---

8. See id.
12. See id. at 776–77.
existing system for restructuring sovereign debt is deeply dysfunctional and produces bad law. As before, I do not care whether the outcome of my experiment is called “bankruptcy.” But if it makes me a fellow traveler, I would be honored.

With this goal in mind, my Commentary proceeds as follows. First, I lay out the dominant arguments for sovereign bankruptcy and why I think they miss the mark. Second, I identify what are, in my view, the key problems with the prevailing regime for sovereign debt restructuring. These include the unenforceable-yet-nondischargeable character of sovereign debt, fragmentation of the debt stock and of the debt restructuring process, and the overall lack of transparency and legitimacy in debt restructuring. Until now, sovereign immunity has been just barely good enough to preempt demand for a more elaborate institutional restructuring mechanism. However, recent developments in Argentina and Greece highlight the shortcomings of sovereignty as a restructuring regime. With or without immunity, sovereigns get no fresh start. The lack of legitimacy in sovereign restructuring is especially troublesome when it brings about large-scale redistribution within and across societies, and even across generations. Having identified the problems, I proceed to sketch out core features of an institutional response.

I conclude by adding a federalism overlay to my thought experiment. Fiscal federalism can exacerbate some of the problems with sovereign debt restructuring that I identified earlier. Formally embedding a debt restructuring mechanism in a federal bargain can help mitigate these problems. However, it would also require unprecedented political consensus. I suggest

13. See infra Part II.
14. See infra Part III.
17. See Anna Gelpern, Odious, Not Debt, LAW & CONTEMP. PROBS., Summer 2007, at 100 (discussing the impossibility of a fresh start despite successive debt relief initiatives for poor countries).
18. See Lee C. Buchheit & G. Mitu Gulati, Responsible Sovereign Lending and Borrowing, LAW & CONTEMP. PROBS., Fall 2010, at 63, 69–70 (explaining the intergenerational tensions created by sovereign borrowing).
that Europe could achieve such a consensus as part of its broader renegotiation of the federal arrangement.

II. WHY BANKRUPTCY?

The affirmative case for sovereign bankruptcy is assumed surprisingly often from the fact that governments have too much debt or the wrong sort of debt. The debate then moves immediately to discrediting objections to bankruptcy, many of which are weak indeed. In this Part, I try to tease out the prevailing affirmative case, and suggest why I think most of the arguments in favor of bankruptcy are not entirely convincing.

A. Too Much Debt, Wrong Sort of Debt

The three biggest substantive arguments for bankruptcy are really arguments for debt relief. I have discussed them at length before; what follows is a brief overview. First, bankruptcy is proposed as a solution to debt overhang—which, for sovereigns, means a level of indebtedness that dissuades future investment and distorts a country's incentives by diverting to the creditors any returns on painful policy reforms. This is an efficiency argument popular with economists and dominant among the policy set. It keys off a particular debt threshold; the precise formula for finding the threshold is heavily contested. A distinct but related argument, usually advanced by religious and civil society groups, is that excess debt takes away a country’s autonomy. The threshold of overindebtedness need
not be the same as in the overhang argument, nor is the threshold calculated with mathematical precision. Rather, the task is to find the point at which a government becomes effectively beholden to its creditors. As with overhang, the threshold might be different for different countries depending on factors such as resource endowment, domestic politics, and policy capacity.\textsuperscript{27}

The third overarching argument for sovereign bankruptcy—Odious Debt—also originates most often with civil society groups. It has gained broad currency in the wake of regime change in Iraq, and Ecuador’s debt repudiation.\textsuperscript{28} The basis for debt relief in the Odious Debt argument is the illegitimate provenance of the debt, not its excessive level.\textsuperscript{29}

In all three cases, the problem is debt. In the first two, the solution is to reduce the debt to a level consistent with efficiency and autonomy, respectively. In the third, it is to eliminate illegitimate debt. Such solutions can be achieved through unilateral default or debt forgiveness, selective repudiation, ad hoc renegotiation, third-party transfers (bailouts in the pejorative), or bankruptcy.\textsuperscript{30} All but bankruptcy are staples in

\begin{itemize}
\item \textsuperscript{27} See Das, Papaioannou & Trebesch, \textit{supra} note 9, at 69–71.
\item \textsuperscript{30} See Gelpern, \textit{supra} note 6, at 927, 930–31.
\end{itemize}
sovereign practice.\textsuperscript{31} Since 1990, dozens of countries have rescheduled, reduced, and eliminated hundreds of billions of dollars in debt.\textsuperscript{32} Several middle-income countries have reduced their debts by over 70%; some of the world’s poorest countries have eliminated nearly all their debts.\textsuperscript{33}

Put differently, bankruptcy is not the obvious answer to the debt problems of sovereigns—worse, it seems to be a uniquely disfavored answer. The most urgent task for bankruptcy proponents, then, is not to dispel reflexive warnings of bond market panic from contract modification. It is to explain how bankruptcy might be superior to the well-worn alternative paths to debt relief, so much so as to justify diverting considerable political and economic resources to establish a new institutional framework. I devote the remainder of this Part to the most prominent explanations in this vein.

B. Coordination Problems

Private creditor coordination problems are by far the leading justification for sovereign bankruptcy in the policy mainstream.\textsuperscript{34} The narrative holds that between the 1980s and the 1990s, sovereign debt transformed from loans to bonds; that loans were easy to restructure because they were held by a small number of regulated, relationship-driven commercial banks; and that bonds were hard to restructure because they were held by hordes of wild bondholders, who were not nearly as civic-minded as the


banks.\textsuperscript{35} Whereas banks waited and restructured, bondholders would rush to sue and strip assets.\textsuperscript{36}

This narrative was always stylized: some countries like Mexico had hundreds of unruly bank creditors in the 1980s,\textsuperscript{37} while others like Pakistan had a small handful of reasonably persuadable bondholders in the 1990s.\textsuperscript{38} Anecdotal evidence of relatively brisk and uneventful bond restructuring in the late 1990s and early 2000s seemed to dispel predictions of another “lost decade”—the time it took to get sovereign loans off the books of undercapitalized banks in the United States and Europe.\textsuperscript{39} Recent empirical studies confirm that, contrary to predictions, holdouts have not held up many sovereign bond restructurings, and that litigation has not been a widespread problem either.\textsuperscript{40}

Commentators have attributed this record of success to contractual tools and transactional tactics.\textsuperscript{41} Majority voting, aggregation across the debt stock, minimum participation, and exit consents have all played important parts in the story; however, the residual power of sovereign immunity remains a disincentive to hold out and especially to sue.\textsuperscript{42} The fact that until now, sovereign debt has been essentially unenforceable thanks to immunity, clearly affects the bargaining between a distressed sovereign and its creditors, and may even help determine the

\begin{itemize}
\item \textsuperscript{35} Hagan, supra note 34, at 308–10; see also Gelpern, supra note 6, at 903–04.
\item \textsuperscript{38} See STURZENEGGER & ZETTELMEYER, supra note 32, at 140–44.
\item \textsuperscript{39} See generally id. at 83–230; Das, Papaioannou & Trebesch, supra note 9.
\item \textsuperscript{41} Bi, Chamoun & Zettelmeyer, supra note 9, at 7–8.
\item \textsuperscript{42} See Bolton & Skeel, supra note 1, at 765, 772–74; Panizza, Sturzenegger & Zettelmeyer, supra note 31, at 673.
\end{itemize}
outcome. Evidence that litigation did not skyrocket as the debt stock morphed from loans to bonds and bond defaults started happening bolsters the immunity hypothesis.

In sum, whatever the reason, so far there is little evidence that private creditor coordination problems delay or disrupt sovereign debt restructurings, nor that a new solution is necessary.

C. Delay and Taboo

Governments, much like people and firms, are incorrigible procrastinators when it comes to acknowledging and dealing with debt problems. Anecdotal evidence suggests that sovereign debtors tend to initiate restructuring later than the academic and policy opinion says they should. Firms, people, and states all struggle with the intractable line between illiquidity and insolvency; everyone will claim temporary illiquidity until long past the point of credibility. But sovereigns have unique additional incentives to delay. First, the spillover effects of public debt default or restructuring on the domestic economy have no analogue in private debt. Currency collapse and bank runs are to be expected when the defaulting government issues its own currency and when government debt is the dominant asset in domestic banks. Trade disruptions and macroeconomic

44. See Panizza, Sturzenegger & Zettelmeyer, supra note 31, at 653–54.
45. Schumacher, Trebesch & Enderlein, supra note 40, at 2–3. Although the authors find that the number of lawsuits filed against countries has risen since the 1980s, they observe that litigation remains rare, and is correlated with the magnitude of creditor losses (“haircuts”) rather than the existence of a liquid secondary market in the country’s debt.
47. See, e.g., Zettelmeyer, Trebesch & Gulati, supra note 16, at 49; see also Michael Mussa, Argentina and the Fund: From Triumph to Tragedy 4 (2002) (criticizing IMF disbursements that helped Argentina delay the inevitable debt default by six months, followed by restructuring nearly five years later).
49. See Reinhardt & Rogoff, supra note 48, at 73–77; Panizza, Sturzenegger & Zettelmeyer, supra note 31, at 652–53.
contraction will likely follow suit.\textsuperscript{51} Second, elected leaders have no incentive to preside over an unraveling and every incentive to gamble for resurrection.\textsuperscript{52} Default becomes politically attractive only when other cards have been played, and the national psyche has had a chance to adjust to the prospect of national failure.\textsuperscript{53} Third, the promise of third-party rescue—a bailout option held by some combination of regional partners, rich country governments, and international institutions; and exercised in the interests of the guarantor or the system—helps keep the game going past viability, often with the result that a country incurs more debt from the rescue and later defaults anyway. The bailout option is an underemphasized cause of delay and uncertainty.

Here bankruptcy faces the same challenge as default or restructuring. If sovereigns try to avoid restructuring at all costs,\textsuperscript{54} what would make bankruptcy filing more attractive earlier? For individuals and firms, bankruptcy offers, among other things, a shield from enforcement and a means to overcome collective action problems.\textsuperscript{55} Even so, personal and corporate filings do not reveal a pattern of early diagnosis and cure.\textsuperscript{56} Sovereigns already have immunity to shield them from enforcement and a mix of immunity and transactional tools to overcome collective action problems.\textsuperscript{57} For bankruptcy to improve on the sovereign status quo, it must have a way to deal with the spillover effects of default, the time-inconsistency of politicians, and the bailout option in the official sector—or at least some subset of the three. Otherwise, it is hard to see how bankruptcy would overcome countries’ reluctance to face up to their debt problems any better than the options now on the table.

\textsuperscript{51} Reinhart & Rogoff, supra note 48, at 57–58.
\textsuperscript{52} See Bolton & Skeel, supra note 1, at 770–71; Hagan, supra note 34, at 306. In this respect, they may not be that different from corporate leaders—but their time horizons are different, and their tenure in office is determined differently. See Bolton & Skeel, supra note 1, at 770–71.
\textsuperscript{54} See Hagan, supra note 34, at 316–17; see also Bettina Nunner-Krautgasser, The Importance of Being Prepared—A Call for a European Sovereign Debt Restructuring Mechanism 1 (unpublished manuscript) (on file with Houston Law Review).
\textsuperscript{55} Bolton & Skeel, supra note 1, at 780–81.
\textsuperscript{57} Bolton & Skeel, supra note 1, at 780–81; Gelpern, supra note 6, at 898–902.
D. Chaos Theories

Yet another argument comes from those who see bankruptcy as rules and a roadmap. They say that today’s sovereign restructuring practice is a hopeless muddle and, crucially, that this uncertainty about rules is delaying fair and efficient debt adjustment.58 This argument is suspect because the modern sovereign debt restructuring process has been quite predictable for decades. It has evolved slowly since the early 1980s, responding to shocks from periodic crises, through continuous bargaining in a tight circle of influential policy makers, market participants, and lawyers.59

When a country decides to ask for relief, it generally secures an economic reform and interim financing program from the International Monetary Fund (IMF), which specifies the financing gap during the program period (usually three years) and a projected path to debt sustainability.60 The debtor then goes to its government creditors, who agree to grant relief according to one of several preset stock- and flow-reduction formulas, and obtain the debtor’s commitment to get “comparability of treatment” from other public and private creditors.61 From there, the debtor may undertake some combination of bond exchange and loan renegotiation with its foreign private creditors on terms more or less in line with those granted by the official sector.62 When debt to domestic creditors is important, it too might be restructured by contract or fiat.63 For the poorest countries, additional bilateral and multilateral relief


59. See generally RIEFFEL, supra note 32, at 18–21 (describing the evolution of modern sovereign debt restructuring procedures through the 1990s); STURZENEGGER & ZETTELMEYER, supra note 32, at 17–18, 22 (describing the same into the 2000s).


63. See STURZENEGGER & ZETTELMEYER, supra note 32, at 216–24 (describing Uruguay’s restructuring of its domestic and international debt).
may be available under programs established by the IMF and the multilateral development banks. Crucially, the process is dominated by a small group of repeat players. This is partly a function of the tiny number of sovereign governments compared to potentially insolvent firms and individuals, but also of the tight community with considerable norm-generating capacity that emerged out of repeated restructurings since the 1980s.

Even apparently novel cases—such as the Greek debt restructuring in the spring of 2012—do not suffer from process unpredictability. Notwithstanding claims that the reckoning was delayed because officials and market participants did not know what to do, the precise sequence of the operation, including the time frame, was spelled out in a widely read white paper by an eminent sovereign practitioner and academic, written almost two years before the restructuring. A bankers’ association helped facilitate the restructuring using a code of conduct it had been promoting for years. Europe knew exactly what to do; it just did not want to do it.

To be sure, the process is fragmented, exclusive, and opaque—unintelligible to the general public—serious problems to which I will return below. However, this is not a case of protagonists stalled because they do not know the dance steps.

E. Fragmentation, Selectivity, Discrimination

Sovereign debt is restructured in multiple fora, loosely linked through financing conditionality and informal undertakings, such as the promise of comparability. There is no way for one group of creditors to ensure that another participates

64. See Multilateral Debt Relief Initiative, supra note 33, at 1.
69. Hagan, supra note 34, at 325–26, 334, 347; Das, Papaioannou, & Trebesch, supra note 9, at 13–17.
in burden sharing and is treated equitably relative to the rest.\footnote{70}{See Hagan, supra note 34, at 316–17; Hugh Bronstein, Argentina Aims at Bond ‘Holdouts’ Ahead of Court Showdown, \textit{REUTERS} (Feb. 2, 2013 11:47 AM), http://www.reuters.com/article/2013/02/02/us-argentina-debt-idUSBRE9110A120130202. As in the Paris Club comparability example, each group might try to pressure the others indirectly through the debtor, and by threatening to pull out and leave the financing gap open.}
The legal regimes implicated by different categories of debt are very different, spanning the national laws of many foreign states, public international law, the charters of international organizations, and the domestic law of the borrower.\footnote{71}{See \textit{Articles of Agreement of the International Monetary Fund} art. 1, Dec. 27, 1945, 2 \textit{U.N.T.S.} 39, 40; Das, Papaioannou, & Trebesch, \textit{supra} note 17, at 6 tbl.13; Panizza, Sturzenegger & Zettelmeyer, \textit{supra} note 31, at 652–54.}
Debt enforcement across jurisdictions adds another layer of complexity.\footnote{72}{In an extreme example, a judgment issued under New York or English law may be enforced under the laws of Ghana, which are then trumped by a public international tribunal established to adjudicate disputes concerning the law of the sea. The “ARA Libertad” Case (Arg. v. Ghana), Case No. 20, Order of Dec. 15, 2012, at 18–19, available at http://www.itlos.org/fileadmin/itlos/documents/cases/case_no.20/C20_Order_15.12.2012.corr.pdf.}


Some categories of debt have been excluded from restructuring by custom. Tradable bonds were famously among these in the late 1990s, along with multilateral loans, short-term trade credits, and domestic obligations.\footnote{75}{RIEFFEL, \textit{supra} note 32, at 35, 37; Das, Papaioannou, & Trebesch, \textit{supra} note 9, at 95.} Traditionally excluded debts enjoy de facto senior status—until they do not, as
bondholders found out at the end of the twentieth century.\textsuperscript{76} When debt that claims to be senior forms a large part of the debt stock, it is almost invariably restructured to help restore debt sustainability.\textsuperscript{77}

Recent European experience illustrates the problem. The European Central Bank (ECB) came to hold a large portion of the Greek debt stock as part of its early efforts to keep down the interest rates in debt-ridden member states.\textsuperscript{78} It refused to participate in the Greek debt exchange claiming that to do so would violate EU treaty prohibitions on monetary financing.\textsuperscript{79} Greece, its private bankers, EU and IMF officials, and other participants in the process effectively acquiesced in the ECB’s claim: Greece exchanged the bonds held by the central bank for ones identical in all respects but the serial numbers, then proceeded to exclude the new serial numbers from its restructuring offer.\textsuperscript{80} This ex post, ad hoc grant of seniority did not go without protest—most notably, Norway’s sovereign wealth fund sold off its holdings of Irish and Portuguese debt after being subordinated to the ECB in Greece, though it did not block the Greek restructuring.\textsuperscript{81}

A few short months after the Greek exchange, the ECB announced a new bond buying program to reduce interest rates and support sovereign debt markets in Europe—this time prompted by concerns over larger economies, such as Spain and Italy.\textsuperscript{82} Mindful of the experience in Greece, market participants

\begin{footnotes}
\item 76. See Nouriel Roubini & Brad Setser, Bailouts or Bail-Ins? 251–56 (2004); Gelpern, supra note 1, at 1127–29.
\item 80. Zettelmeyer, Trebesch & Gulati, supra note 16, at 5–6, 25.
\end{footnotes}
and others said that ECB bond buying would be a negative for distressed sovereigns. Instead of seeing a fresh new secondary market, creditors saw a giant usurper zooming to the head of the distribution line. The ECB responded by reversing its position and promising not to claim seniority; it even figured out how to square the monetary financing circle under the treaties. Time will tell whether this commitment would bring the ECB into a sovereign debt restructuring on par with private creditors.

An important advantage of bankruptcy for firms and individuals is its capacity for comprehensive coverage and process centralization. It makes economic and political sense to collect and adjust all claims against the debtor in a single forum under a single set of rules, and to pay claims out of a unified set of assets. Comprehensive coverage and centralization make it more likely that relief will be effective, that all stakeholders will be treated equitably, and that the process will enjoy legitimacy. Taking claims or assets out of the bankruptcy process—as in the swaps carve-out in the case of claims, or the homestead exemption in the case of assets—is a consequential step that requires serious policy justification. Comprehensive coverage and centralization may be harder to achieve in a sovereign restructuring process precisely because the applicable legal regimes are so diverse, and there is no readily available source of supranational authority to preside over the competing claims.

F. Overborrowing and Dilution

In the paper I cited at the start of this Commentary, Patrick Bolton and David Skeel showed that sovereigns are especially prone to overborrowing because they are not bound by an enforceable system of payment priorities. An overindebted sovereign retains access to financing long past the time it should

88. Bolton & Skeel, supra note 1, at 788–90, 792.
because new creditors expect to share in the resources that would have gone to repay the old, or might even secure a side promise of preferential treatment. The old creditors’ claims are effectively diluted because a sovereign suffering from a debt overhang does not improve its payment capacity with new borrowing—it is merely accumulating more claims against the same old assets and revenues. Expecting later dilution, longer term creditors might charge more to lend to a solvent sovereign. In U.S. bankruptcy, incentives to overborrow are limited because it enforces statutory and contractual priorities and voids preferential transfers on the eve of a bankruptcy filing. An insolvent debtor has few ways of digging the hole deeper.

The lack of enforceable priorities is clearly a problem, but not one that can support an argument for a full-blown bankruptcy regime—just for a regime in which a debtor and a creditor can agree on repayment priority at borrowing, and see the agreement enforced in distress. Recent proposals to reform the European sovereign debt markets are instructive. One of the most prominent—the “Blue Bond/Red Bond” proposal—would effectively create a senior category of debt (blue bonds) by mutualizing all member state bond obligations that, in the aggregate, are at or below European treaty debt thresholds. Borrowing over the limit (red bonds) would cost member states more because repayment would be their several responsibility when they are, by definition, overindebted.

Stratification here is achieved by ex ante guarantees. I have proposed elsewhere that it be done by contract. A reasonable objection to the use of ex ante guarantees is that it amounts to a bailout fund with moral hazard potential. A

---

89. Id. at 792–95.
90. See id. at 790–91.
92. But see generally William W. Bratton, Pari Passu and a Distressed Sovereign’s Rational Choices, 53 EMOY L.J. 823 (2004) (arguing that sovereign debt contract interpretation produces multiple conflicting meanings for the debt ranking term, and even if such contract terms were enforceable, they could be indeterminate absent statutory bankruptcy).
94. Id. at 2–5.
95. Id. at 2.
96. See Gelpern, supra note 1, at 1119.
97. See Bolton & Skeel, supra note 1, at 764; Delpla & von Weizsäcker, supra note 93, at 3. I discuss moral hazard concerns later in this Commentary. See infra Part II.H.
powerful objection to stratification by contract is that sovereign commitments are unenforceable, and there is no reason to believe that a commitment to payment priority would fare any better than a commitment to payment.\textsuperscript{98} Even if one were to concede the enforcement point, bankruptcy has no particular advantage here. If anything, because it involves more elaborate commitments, it is more vulnerable to the same objection,\textsuperscript{99} unless enforcement is simply assumed from the statutory (treaty) nature of sovereign bankruptcy. If the enforcement problem is solved, contractual priorities become viable.

G. Interim Financing

The debtor’s need for interim financing during reorganization is often cited as a distinct argument for sovereign bankruptcy.\textsuperscript{100} It is probably best viewed as a subcategory of the priorities challenge. If a debtor were able to grant enforceable priority status to private creditors during reorganization, they should be more willing to lend.

Sovereign debtors already get priority financing conditional on policy reform during the adjustment period—it comes from the IMF and other international institutions.\textsuperscript{101} The priority status of multilateral financing is occasionally questioned;\textsuperscript{102} when new sources materialize, they must be integrated in the existing customary scheme. Recent controversy surrounding the European Stability Mechanism (ESM) is instructive.

\textsuperscript{98.} See Bolton & Skeel, supra note 1, at 793.
\textsuperscript{99.} Gelpern, supra note 1, at 1116–18, 1122–23, 1126.
\textsuperscript{100.} Hagan, supra note 34, at 374–76; Ugo Panizza, Do We Need a Mechanism for Solving Sovereign Debt Crises? A Rule-Based Discussion 6–7 (Graduate Inst. of Int’l & Dev. Studies, Working Paper No. 03/2013, 2013) (arguing that under current unstructured approaches, private creditors are discouraged from providing financing to sovereigns, amplifying financial crises).
\textsuperscript{101.} See Shean Hagan, Sovereign Debtors, Private Creditors, and the IMF, 8 LAW & BUS. REV. AM. 49, 50 (2003); Das, Papaioannou, & Trebesch, supra note 9, at 14.
The ESM was conceived as a regional crisis response framework. It emerged out of dissatisfaction with the ad hoc management of the Greek debt restructuring and its effect elsewhere in Europe. One could even think of it as a proto-bankruptcy regime—a characterization I consider in my conclusions. Among other things, the ESM would provide financing to eurozone countries in distress “strictly conditional” on policy reform. Treaty recitals seem to suggest that ESM has a legal claim to priority repayment, second in line to only the IMF. There are two problems with this assertion. First, the IMF and other established multilaterals, such as the World Bank, assiduously avoid claiming legal priority. Their so-called preferred creditor status is a matter of practice. European claims with respect to the ESM muddied the waters for the system as a whole. An awkward compromise followed: European officials backtracked on the seniority claim in public announcements and kept it out of the operative treaty provisions. However, uncertainty remained, and came back to haunt eurozone policy makers when it was proposed that the ESM finance Spanish bank recapitalization. As with ECB financing discussed earlier, massive confusion ensued among creditors as to whether they were being saved or subordinated thanks to ESM financing for Spanish banks.

105. See Treaty Establishing the European Stability Mechanism, supra note 103, at 3.
106. See id. at 7.
108. See Treaty Establishing the European Stability Mechanism, supra note 103, at 7; Draghi, supra note 83; Joshua Chaffin, No Special Status for Eurozone Bonds, FIN. TIMES (LONDON) (June 20, 2011), http://www.ft.com/intl/cms/s/0/5e370954-9b49-11e0-a254-00144feabdc0.html#axzz2NNVQ1q6t.
The upshot of the interim financing argument is this: if governments and international organizations have enough funding to meet the entire interim financing need, the international financial institutions’ reasonably successful half century as “preferred creditors” suggests that a bankruptcy regime may be superfluous for now. However, as larger economies become insolvent, as willingness to fund international organizations goes down, and as new regional, multilateral, and private financiers enter the fray, the question of priority for such financing is bound to return. Even so, it remains a question of granting enforceable priority—not bankruptcy—subject to all the qualifications in the preceding section.

H. Bailouts and Moral Hazard

The debate over ex post third-party rescues—or bailouts—has produced an important and still-growing law literature, which received a big boost from the financial crisis in 2008. It joins the writing from other disciplines and earlier crises. Professors Skeel and Gillette are among the leading contributors to this literature. This Commentary is not the place to reprise or arbitrate among the different contributions. Rather than ask whether bailouts are always bad or how to tell the good and the bad apart, I wonder whether bankruptcy necessarily—or even likely—would lead to fewer bailouts for sovereign states.

This is, at bottom, the “too big to fail” debate: whether debtors whose default or restructuring would cause intolerable spillover effects could nevertheless be allowed to go under. States, even more than banks, are nearly always too big to fail.

111. See, e.g., Levitin, supra note 53, at 437–38, 490–92; Skeel, supra note 19, at 680, 691, 704–06.
David Skeel has argued forcefully that bankruptcy can be a viable alternative to bailouts for banks and states alike.\textsuperscript{116} I remain convinced that in systemically important cases, public finance and debt restructuring will proceed side by side—as in the U.S. auto bailout\textsuperscript{117} and in the nascent European crisis management regime.\textsuperscript{118} For bankruptcy to preempt, foreclose, or even limit bailouts, debtors, creditors, and potential spillover victims would have to invoke it early, before collateral damage spreads. This in turn requires a high degree of political support for loss recognition and distribution.\textsuperscript{119} Bankruptcy’s advantage over default or ad hoc restructuring is in its prenegotiated distribution bargain. Whether any such bargain can hold in a systemic crisis is an open question. But experience in the United States since 2008 and Europe since 2010 inspires skepticism.

\textbf{I. Illegitimacy and Capture}

The last of the prevailing arguments for sovereign bankruptcy addresses the politics head on. Advanced principally by civil society groups, this argument is most concerned with the second and third debt problems of the lot I described at the start of this Part (debtor autonomy and debt provenance),\textsuperscript{120} but also with process illegitimacy. From this perspective, the debt restructuring process is captured by technocrats obsessed with efficiency, who are in turn captured by rich country politicians and bankers, so as to ensure that the burden of adjustment falls on the poor, while the rich are protected.\textsuperscript{121} Even if coordination problems did not exist, if interim financing were freely available, and if debtors restructured at the first sign of trouble, the result would be illegitimate because it would distribute losses to those least able to bear them, and would repay or adjust debts without regard to their provenance.\textsuperscript{122} An analogous argument has been

\textsuperscript{116} Kenneth Ayotte & David A. Skeel, Jr., \textit{Bankruptcy or Bailouts?}, 35 J. CORP. L. 469, 471 (2010); Skeel, supra note 19, at 689–707.


\textsuperscript{118} See Treaty Establishing the European Stability Mechanism, supra note 103.

\textsuperscript{119} See Blackman & Mukhi, supra note 15, at 47; Vlasic & Sanger, supra note 117.

\textsuperscript{120} See supra text accompanying notes 26–29.


made at the opposite end of the political spectrum in the United States: Newt Gingrich and Jeb Bush supported state bankruptcy as a way of breaking the grip of public employee unions on state fiscal policy.\textsuperscript{123} Bankruptcy is needed to correct distribution; it is not at all agnostic about substantive content.

Bankruptcy proposals advanced by global civil society groups from this vantage point emphasize process transparency and stakeholder inclusion, including audits and dispute resolution fora, such as the Fair and Transparent Arbitration Process (FTAP) supported by the Jubilee Coalition.

Some scholars and practitioners have suggested that greater legitimacy may be achieved by adapting common law doctrines of fraud and duress, as well as principles of agency law, without recourse to bankruptcy.\textsuperscript{124} Lending and restructuring institutions, formal and informal, have responded to criticism from nongovernmental organizations (NGOs) by improving transparency and having regular civil society consultations.\textsuperscript{125} Even so, it is hard to argue with the basic proposition: a process that has such a profound impact on national, cross-border, and intergenerational resource distribution\textsuperscript{126} should be robustly politically accountable; common law victories and website disclosure are not enough.

But the unlikely common ground between the Jubilee Coalition and Newt Gingrich points to a different question: how might one design a sovereign bankruptcy regime that is captured by the right, not the wrong, people—or one that is politically accountable across the political spectrum? For example, Chapter 9 of the U.S. Bankruptcy Code, which governs municipal bankruptcy and serves as a model for some of the most progressive sovereign bankruptcy proposals, enables holders of revenue bonds to collect from post-petition receivables unavailable to creditors of a corporation in Chapter 11 reorganization, and fails to give priority for pension and labor

\begin{flushleft}
\textsuperscript{126} See Buchheit & Gulati, \textit{supra} note 18, at 69–70.
\end{flushleft}
obligations as readily as corporate bankruptcy does. It is a sign of bankruptcy’s “capture” by capital at the expense of labor. If both bankruptcy and informal restructuring are arguably prone to capture, what makes bankruptcy the superior option?

This Part of my Commentary summarized the prevailing arguments for sovereign bankruptcy. Together, they expose serious shortcomings in the existing sovereign debt restructuring process. However, they also stop short of demonstrating that any existing institutional iteration of bankruptcy or bankruptcy proposal would offer a better path. In most cases, sovereign bankruptcy proposals assume away, but fail to solve, the biggest challenges to the existing process. The next Part is an effort to reframe the challenge of sovereign debt restructuring in search of a different argument for bankruptcy.

III. CORE PROBLEMS AND BANKRUPTCY IMPLICATIONS

A. Unenforceable Debt

Since the mid-twentieth century, it has been relatively easy to sue sovereigns that issue debt under foreign law in foreign courts. However, enforcing judgments is virtually impossible because there are few assets outside a debtor’s borders available for attachment. The past decade of battles between Argentina and its creditors illustrates this problem. The European debt


130. See Seijas v. Republic of Argentina, 606 F.3d 53, 55–58 (2d Cir. 2010); Ross P. Buckley, Why Are Developing Nations So Slow to Play the Default Card in
A SKEPTIC’S CASE

2013]

CRISIS has brought attention to the fact that most of the world’s sovereign debt is issued under the law of the sovereign itself, giving the debtor more leverage over the terms of its debt restructuring.131

At first blush, robust asset immunity seems to have helped mitigate many of the collective action problems that motivate business and personal bankruptcy.132 On closer inspection, immunity appears an increasingly fragile patchwork of national and international norms.133 While it may still dissuade mass litigation—chasing sovereign assets around the globe requires vast resources and patience—it leads to unpredictable enforcement strategies and makes bad law. For example, a tiny fraction of Argentina’s creditors that rejected restructuring offers after the 2001 default has tried to nab payments to other creditors in New York,134 diplomatic property in Maryland,135 a presidential airplane in Germany,136 and a military ship in Ghana.137 Although creditors’ recovery has been meager to date, over the past few years, they have secured breakthrough rulings in Belgium, France, Ghana, Hong Kong, and the United States—taking advantage of subtle differences in commercial and immunity laws among jurisdictions.138 The October 2012 ruling from the U.S. Court of Appeals for the Second Circuit, which

132. See Skeel, supra note 19, at 685–86.
133. See Blackman & Mukhi, supra note 15, at 48–49.
allows holders of defaulted bonds to block payments on performing debt, may be the last straw for immunity from enforcement, though it is too early to know for sure.\textsuperscript{139}

The result is shaping up to be a paradox: on the one hand, Argentina appears to have walked away from billions of dollars' worth of admittedly legal, valid, and binding debt contracts with impunity.\textsuperscript{140} A decade on, holdouts have been paid a tiny fraction of what they are owed\textsuperscript{141}—not an attractive business model so far. On the other hand, Argentina is harassed at every turn, with increasingly odd theories of contract interpretation and sovereign immunity reshaping the legal landscape—as collateral damage grows.

The Greek debt restructuring taught a different lesson. Because over 90% of Greece's private debt stock was governed by Greek law, Greece restructured it with the help of a domestic statute that unilaterally and retroactively grafted a majority amendment mechanism across Greek bonds, using voting thresholds exceedingly favorable to the debtor.\textsuperscript{142} On the one hand, it was generous of Greece to let bondholders vote at all—it could have simply reduced the debt by fiat, or imposed a 70% withholding tax on bond payments.\textsuperscript{143} Moreover, Greece made an elaborate effort to negotiate with its creditors and it deployed retroactive legislation as a last resort, with the apparent knowledge of those who planned to participate.\textsuperscript{144} Nevertheless, the import of the unilateral retroactive statute was not lost on the creditor community, a portion of which complained of lawlessness and compared Greece to Argentina.\textsuperscript{145}

\begin{thebibliography}{100}
\bibitem{140} See Porzecanski, supra note 130, at 317.
\bibitem{141} J.F. Hornbeck, Cong. Research Serv., R41029, \textit{Argentina's Defaulted Sovereign Debt: Dealing with the "Holdouts"} 3, 7 (2010).
\bibitem{142} Buchheit & Gulati, supra note 18; Zettelmeyer, Trebesch & Gulati, supra note 16, at 7, 25–28.
\bibitem{143} See Zettelmeyer, Trebesch & Gulati, supra note 16, at 7.
\bibitem{144} See id.
\end{thebibliography}
In sum, the immunity shield is just barely good enough to preempt demand for bankruptcy protections on the part of the debtors and a majority of creditors who seek a quick and orderly restructuring. On the other hand, Argentina and Greece are bad news for creditors that seek predictable recoveries. This suggests that there may be room for an old-time bankruptcy bargain, in which the debtor hands over property to the creditors as a group in exchange for discharge and protection from harassment by individual creditors.146 I return to the potential shape of such a bargain at the end of this Part.147

B. Nondischargeable Debt

Sovereign debt is forever: it cannot be discharged without creditors’ consent. Debtors might simply walk away, subject to the constraints described in the preceding section. Contractual techniques—such as majority amendment provisions, especially ones that permit aggregated voting across bond series and other debt instruments—can help overcome holdout.148 However, majority amendment provisions without more appear to make little difference in the restructuring outcome, while aggregation provisions are extremely rare.149 When they exist, such provisions operate across bond series, never across different kinds of debt.150

As a result, the idea of a truly fresh start is essentially inconceivable for a sovereign. Even when most creditors agree to go along with a restructuring, it is virtually guaranteed that there will remain some debt somewhere that could come back to piggyback on other creditors’ concessions.151 By that point, the debtor may be in a position to settle such debt on the side. At a minimum, this scenario raises concerns with intercreditor equity and incentives for future restructuring.

147. See infra Part III.E.
149. Gelpern & Gulati, supra note 148, at 1706.
C. Debt Fragmentation

The biggest creditor coordination problem in sovereign debt occurs not within, but among different creditor groups, such as official and private, domestic and foreign, and bilateral and multilateral creditors.152 The fight for repayment priority in distress has only recently started to make headlines, but has long been among the dominant drivers of uncertainty and delay in restructuring.153 Greece did not wait for two years to restructure because its bondholders failed to agree on a haircut or rushed to the courthouse, but rather because its bondholders, EU officials, the IMF, and the ECB could not agree on allocating losses among taxpayers in Greece, in Europe, and elsewhere around the world.154

A related concern already mentioned in Part II is that the well-oiled sovereign restructuring process is utterly unintelligible to the public.155 Because different debt categories are restructured in different and formally unconnected fora, under different rules, with different avenues for dispute resolution, it is difficult to impossible for the people affected by the outcome—be it debtor country taxpayers or pensioners whose funds invested in the debt—to get a comprehensive view of the process or to be heard in a meaningful way.156 This detracts from the overall legitimacy of the restructuring regime, to which I turn next.

D. Authority and Legitimacy

At the start of Part II, I mentioned three arguments for sovereign debt restructuring: efficiency (framed as debt sustainability), autonomy (Jubilee), and legitimacy (Odious Debt).157 Sustainability is the first and most successful of the


153. ROUBINI & SETSER, supra note 76, at 249–87.


155. See supra Part II.D.

156. See Steven L Schwarcz, “Idiot’s Guide” to Sovereign Debt Restructuring, 53 EMORY L.J. 1189, 1189–90 (2004); Das, Papaioannou & Trebesch, supra note 9, at 12–13 (describing the steps, actors, and various processes involved in sovereign debt restructuring).

157. See supra Part II.A.
three. The level of debt sustainability is currently determined by the IMF; however, the IMF analysis has been the target of vigorous criticism for lack of transparency and political capture. The widely held perception among market participants and civil society observers alike is that IMF sustainability calculations are driven by political expediency, not the scientific method. While this characterization is not entirely fair, it illustrates the legitimacy dilemma in sovereign debt restructuring. When the IMF designs the reform program, provides interim financing, and determines the near-term financing need and the path to sustainability, its determinations become inevitably linked to its own position as a creditor, and its longstanding legitimacy challenges. While the institution remains indispensable, its governance is flawed, still reflecting too much of the post-World War II institutional consensus despite several promising rounds of reform. With creditors and NGOs convinced that the IMF is hopelessly conflicted as a senior creditor with privileged policy access, and with civil society observers also convinced that the IMF is forever captured by capital, the IMF’s expert assessments, and the restructuring process that depends on them, are substantially diminished for lack of trust.

In practice, determinations of autonomy and legitimacy are either self-judging, as in the case of Ecuador, or subsumed in the sustainability conversation, as in the case of Iraq. Proposals to link up this inquiry with the U.N. sanctions

158. See Krugman, supra note 23, at 254–56.
160. See Torres, supra note 159, at 455.
161. Id. at 444–45.
162. See id.
164. See Torres, supra note 159, at 455; 460 (describing the IMF’s selective prioritization of financial liabilities).
165. See Noteholder Circular, supra note 28, at iii; Arturo C. Porzecanski, When Bad Things Happen to Good Sovereign Debt Contracts: The Case of Ecuador, LAW & CONTEMP. PROBS., Fall 2010, at 251, 265–66.
166. Interview by Euromoney with Adil Abdul Mahdi, Minister of Fin. in the Interim Gov’t of Iraq, in Dubai, U.A.E. (2003), in Felix Salmon, Seeking Forgiveness of Saddam-Era Debt, EUROMONEY, Sept. 2004, at 72, 76.
regime, or to set up stand-alone tribunals for such determinations, have failed to take hold so far. To the extent the restructured debt stock remains subject to charges of illegitimacy and the potential for repudiation on “odiousness” grounds, the status quo is problematic for debtors and creditors alike.

E. Bankruptcy Implications

The existing regime for contracting and restructuring sovereign debt is deeply flawed. The debt itself is unenforceable yet nondischargeable. The process for its restructuring is fragmented, its coverage is selective, and it lacks an accountable mechanism to verify claims and establish the necessary level of relief. The most direct response to these flaws is a regime that allows creditors as a group to collect from debtor assets in exchange for the promise of a fresh start.

The tradeoff might include more secured lending, on the model of municipal revenue bonds or the U.S. oil-backed financing for Mexico in 1995. Sovereigns could find the bargain more attractive if it were combined with better protections for other property—such as military ships and presidential airplanes, financial flows to third parties, and payment and clearing systems—and the availability of discharge.

The resulting regime must combine comprehensive coverage with an advance agreement on payment priorities among diverse groups of claimants. The content of any comprehensive priority scheme must be politically determined and enforceable: only a political process can credibly balance the demands of bondholders, pensioners, trade creditors, and other governments. A violation of priorities would come at the cost of discharge, much as it might in non-sovereign bankruptcy. An enforceable priority scheme that enjoys broad-based political support should help create incentives to restructure earlier, force more disclosure at borrowing, and

168. See id. at 741.
169. See supra Part III.A–D.
170. ROBERT E. RUBIN & JACOB WEISBERG, IN AN UNCERTAIN WORLD: TOUGH CHOICES FROM WALL STREET TO WASHINGTON 3–5, 10–11, 14 (2004); Adam J. Levitin, Bankrupt Politics and the Politics of Bankruptcy, 97 CORNELL L. REV. 1399, 1436 (2012).
establish the terms of bargaining among creditor groups in distress. This in turn could affect the sources and availability of interim financing and the terms of the reform and recovery program.

Finally, the regime must incorporate a claims verification process—or at least a process for assessing challenges to the legitimacy of claims—as well as an expert determination of debt sustainability that is publicly accepted as independent of the interests of would-be bailout providers.

Establishing a restructuring regime along these lines is a daunting political challenge. In fact, it may well be a pipe dream. No matter. I started this Commentary by renouncing any aspiration to pragmatism. Even so, there remains the question: would a restructuring regime that stops short of the grand political bargain I have outlined be an improvement over the status quo?

The answer must be, “It depends.” A mechanism along the lines proposed by the IMF in 2001 would facilitate private creditor coordination and effectively serve as a “super-aggregation” mechanism more powerful than Greece’s statutory intervention. It would be useful, but not essential—and probably not worth the political and institutional cost—unless recent developments in Argentina’s litigation produce a generalizable model for overcoming sovereign immunity. If the Second Circuit decision holds up and is interpreted to give holdouts the capacity to block payments on restructured debt, coordination problems might be expected to rise. Absent a rise in coordination problems, the value of a mechanism modeled on the IMF proposal is uncertain.

The FTAP championed by the Jubilee Coalition is inspired by elements of the U.S. municipal bankruptcy regime, particularly its capacity to give voice to a wide range of municipal constituents. FTAP and similar proposals focus on dispute resolution, rather than creditor coordination per se, and

come in two basic varieties: ad hoc and standing. The proposals for an ad hoc tribunal focus on procedural matters, such as the composition of the tribunal, insist on comprehensive debt coverage, and import much of the substance from international human rights law.\textsuperscript{176} Parallel proposals for a standing arbitration tribunal are similar in their procedural focus and potentially comprehensive debt coverage.\textsuperscript{177} Matters within the tribunal’s jurisdiction might range from claim verification and voting disputes to all manner of substantive determinations, including sustainability, “odiousness,” and good faith.\textsuperscript{178} Whereas the ad hoc tribunal proposals seem driven by the ideal of inclusion and human rights principles, the standing tribunal is meant to seed a larger regime whose substantive content would reflect the evolving political consensus and market practice.\textsuperscript{179} Either proposal could be adapted to work within a broader restructuring regime, but neither makes for a regime on its own.\textsuperscript{180}

In sum, a sovereign bankruptcy regime would be a big political project. Some elements, such as overcoming coordination problems within creditor groups or independent dispute resolution, might be adapted to address isolated problems with restructuring. It is unclear whether the problems they would solve warrant institutional change on the proposed scale. More importantly, any statutory debt restructuring regime must be embedded in the broader democratic process.

IV. CONCLUSION: THE FEDERALISM OVERLAY

Most of this Commentary has been about sovereign bankruptcy—which I support in general, even as I have trouble envisioning it in particular. Subsovereigns and quasi-sovereign states present some of the same challenges, notably immunity, but also different ones. Fiscal federalism is the most important of these. For example, as both Professors Skeel

\textsuperscript{176} Raffer, supra note 21, at 368, 371–73, 376.


\textsuperscript{178} See id. at 10–11.

\textsuperscript{179} See id. at 4–6.

\textsuperscript{180} See Jürgen Kaiser, Resolving Sovereign Debt Crises: Towards a Fair and Transparent International Insolvency Framework 22, 23 tbl.2 (2010), available at http://library.fes.de/pdf-files/iez/07497.pdf (analyzing the pros and cons of each proposal). It is doubtful, for example, that PTAP proponents who rely heavily on Chapter 9 would be satisfied with its priority scheme.
and Gillette have pointed out, fiscal federalism presents a special moral hazard challenge: the spillover effects from state financial distress can prompt the federal government to intervene with a bailout for the sake of the other states or the federation as a whole.\footnote{See David A. Skeel, Jr., State Bankruptcy from the Ground Up, in WHEN STATES GO BROKE 191, 211 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012); Gillette, Fiscal Federalism, supra note 113, at 287.} As David Skeel and those he cites suggest, the fiscal bargain can look dramatically different from one federation to the next, and it can change over time.\footnote{Skeel, supra note 21, at 1076–80.} In some arrangements, bailouts are unnecessary in crisis because cross-subsidies are “baked in” throughout; in others, bailouts might be more frequent only because cross-subsidies are minimal in ordinary times.


Against this ever-changing background, it is hard to say that federal bailouts are an unqualified good or bad, or that bankruptcy’s dominant goal should be to make bailouts scant. Some rescues and debt assumptions are better done and better justified than others.
Depending on how it comes out at the end, Europe appears to be in the early stages of negotiating or renegotiating its federal bargain. The previous version of the bargain—the one with the Stability and Growth Pact and the no-bailout clause in EU treaties—has failed. The new one ties promises of fiscal fortitude, via the fiscal compact, to some combination of a rescue fund, a banking union, and contract reform that seeks to facilitate restructuring. Lurking in the background are fundamental arguments over distribution by way of regional deposit insurance and debt mutualization. The result may be vertical federalism, horizontal federalism, or no federalism at all. However, Europe’s federalism negotiation has proceeded through successive treaty amendments, and existing European instruments and pronouncements (notably the ESM treaty) have already done more to formalize sovereign debt restructuring norms than any other in the modern history of sovereign debt. Europe’s evolving “fiscal constitution” has been very explicit about debt restructuring. If the European project were to succeed, I would not be surprised to see proto-bankruptcy features emerging as a core part of the federal bargain, even if it stops short of a full-blown debt restructuring mechanism, as is likely.

I would feel comfortable with such an outcome in Europe because I agree with David Skeel’s key argument: The conversation about sovereign bankruptcy is at heart a conversation about federalism and democracy. It is healthy to

188. See Niall Ferguson & Nouriel Roubini, The Perils of Ignoring History: This Time, Europe Is on the Brink, SPIEGEL ONLINE INT’L (June 12, 2012, 4:45 PM), http://www.spiegel.de/international/europe/the-germans-have-learned-nothing-from-history-a-838429.html.
argue, as we have, about the wisdom of framing this conversation in bankruptcy terms; however, there is no question that debt and debt restructuring belong at the forefront of national, regional, and global governance debates.