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Pari Passu Lost and Found: The Origins of Sovereign Bankruptcy 1798-1873

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ABSTRACT

Verdicts returned by modern courts of justice in the context of sovereign debt lawsuits have upheld a ratable (proportional) interpretation of so-called "*pari passu*" clauses in debt contracts which, literally, promise creditors they will be dealt with equitably. Such verdicts have given individual creditors the right to interfere with payments to others, in situation where the sovereign had failed to make proportional payments. Contract originalists argue that this interpretation of *pari passu* clauses has no historical foundation. Historically, they claim, *pari passu* clauses never granted

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individual creditors a unilateral right to block payments to other bondholders assenting to a government debt restructuring proposal. This article shows this claim is incorrect. Drawing on novel archival research, it argues that *pari passu* clauses find one potent historical origin in the operation of a now forgotten sovereign bankruptcy tribunal, the London stock exchange. Under the law of the stock exchange, departure from ratable payments did create a unilateral right for individual creditors to interfere with sovereign debt discharges. In fact, ratable distributions provided the touchstone for the stock exchange sanctioned sovereign debt discharge system. What is more, sophisticated contract drafters availed themselves of the logic. The result was a weaponization of *pari passu* clauses, and their inscription into sovereign debt covenants in the 19th century. The article concludes that the modern debate on the role of clauses in sovereign debt contracts cannot be held without thorough reconsideration of the history of sovereign bankruptcy.

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PART I. INTRODUCTION

The question of the proper approach to sovereign debt crises has haunted the international financial policy conversation for almost half a century. One significant development of the last two decades has been the debate over the actions of hedge funds specializing in distressed sovereign debt, known to critics as "sovereign debt vultures." Starting in the mid-1990s, they perfected legal-financial investment tactics that rested on buying the bonds of defaulting countries and bringing strategic lawsuits with the objective of cornering defaulters into settling. An instance that attracted significant attention was the successful "holdout" strategy deployed against Peru by Elliott Associates L.P. in 1999. Elliott was a holder of defaulted Peruvian bonds who had rejected a debt conversion offer made by Peru and the strategy consisted in exploiting provisions in sovereign debt contracts known as "*pari passu*" clauses, whose language conjures up notions of equitable treatment among alternative classes of creditors. At a time when no one had offered a decisive interpretation of what *pari passu* meant exactly in the sovereign debt context, Elliott sought to persuade the court that the clause allowed for interference with sovereign payments to creditors. The strategy worked and in September 2000, Elliott obtained a restraining order from the Brussels court of appeal prohibiting Chase Manhattan (the financial agent of Peru) and Euroclear (the settlement system) from paying interest on the bonds of the creditors who had accepted the conversion without making a proportional payment on the bonds Elliott held. The ruling forced Peru to face the prospect of default since the diversion to Elliott meant it would be unable to pay the full dividend to other creditors. The country rushed to settle with Elliott.[1]

Following the Elliott verdict there was a general outcry, critics speaking of a modern act of piracy.[2] Some authors, such as Fisch and Jill (2004), proposed a more balanced view, admitting the possibility of a useful function for sovereign debt "vultures," and suggesting that their interventions could ultimately serve to discipline defaulters. One thing that was sure was that, in borrowing a page from what was at the time the corporate debt playbook, which enables a creditor to interfere with a borrower in bankruptcy, Elliott had reinvented sovereign default as an investment opportunity and brought it within the remit of more ordinary distressed debt investing. Unsurprisingly, such tactics had been part of Elliott's playbook for dealing with distressed corporate debtors in the 80s and 90s.[3] The approach was potent because in practice, behind every sovereign debt restructuring is the threat, veiled or explicit, that the non-converted bonds of possible holdout creditors are not going to be repaid or only much later. This threat is seen as facilitating creditor coordination. But with the new tactic and verdict, non-converted

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[1] See e.g. Olivares-Caminal (2013, p. 124): As the restraining order declared, Peru's bonds "should be paid down equally towards all creditors in proportion to their claim."
[2] On distressed sovereign debt litigation as modern piracy, see Gulati and Klee (2001).
[3] See Frumes and Indap (2021).

bonds commanding low prices on the market became instead a fulcrum security that rendered deploying obstructive tactics in sovereign debt worthwhile.

A concern that emerged after the verdict was returned was that, since *pari passu* clauses were ubiquitous in sovereign debt contracts, the Elliott template would be industrialized. Indeed, the operation was just one episode in a rising tide of sovereign debt litigation.[4] Observers predicted that this would create havoc in the international financial system. A virulent academic and media attack was launched against the Brussels court's interpretation of the clauses. At the time, some commentators predicted that the verdict would not stick when more competent jurisdictions would be involved. Their hopes were dashed when the District Court for the Southern District of New York returned an identical decision in 2014 in a similar dispute, in which NML Capital replicated the Elliott attack in the context of Argentina's default. The decision returned by Judge Griesa (soon turned into a villain) was subjected to even more intense criticism than that of the Brussels court and the ensuing controversy involved public intellectuals including Saskia Sassen and Joseph Stiglitz who proposed to debeak the vultures.[5] The General Assembly of the United Nations adopted a declaration urging limits to the role of vulture funds. Nonetheless, the Griesa ruling was upheld by the U.S. Supreme Court.[6]

It is said that by their actions, vulture funds threaten to undermine the fragile compromises which under IMF tutelage have to be achieved between creditors and debtors. Instead of waiting along with commercial banks for IMF-led debt restructurings to proceed, they proved that jumping to the head of the line could pay. In fact, one result of the Elliott episode was to prompt the IMF under Managing Director Anne O. Krueger to throw its weight behind a Sovereign Debt Restructuring Mechanism. Not coincidentally, this occurred just after the distressed sovereign debt investors' engaging of the Brussels court, and Belgium and against the backdrop of the beginnings of Elliott's holding out against Argentina.[7] The SDRM envisioned the creation of a sovereign debt bankruptcy regime, providing sovereign defaulters with a standstill that would enable them to open negotiations with creditors. In order to render the process more expeditious and prevent holdout obstruction, debt restructurings would be ruled by majority vote and binding on holdouts. The scheme was completed with a Sovereign Debt Dispute Resolution Forum

[4] On the recent historical development of sovereign debt litigation, see Schumacher et al. (2015); Schumacher et al. (2021).
[5] A summary of the situation in the aftermath of the Supreme Court decision in June 2014 is Norris (2014). For public intellectuals' and Op-ed journalists' criticism see Sassen (2014), Stiglitz (2014) and Wolf (2014).
[6] United Nations resolution (69/319) adopted on 10 September 2015 by the General Assembly.
[7] On the IMF proposal see Krueger (2002); For a state of the conversation at the time of the Krueger proposal see for instance Buchheit and Gulati (2002). For a subsequent discussion of prospects for sovereign default, Buckley (2009). For a discussion of the modern experience with debt restructuring, see Buchheit, Chabert, DeLong, and Zettelmeyer (2019).

entrusted with the responsibility to adjust competing claims. On paper at least, the SDRM rendered moot the tactics used by vulture funds.[8]

Because of the pivotal role which *pari passu* clauses played in the whole saga, they attracted considerable interest. The problem is, however, that while everyone agrees that the Latin phrase means "in equal step" or "equally" (indeed, their wording admits in practice a number of variants, such as "ranking equal") there is no consensus as to what this equality amounts to – or ought to amount to – in practice.[9] The decisions of the courts championed one possible reading – that equality of rights meant proportional payments. But was it what contract drafters had in mind when they had included the clauses in the sovereign debt boilerplate? Pondering this question, critics suggested to follow an originalist approach: As they reasoned, if one could trace modern *pari passu* clauses to the first *pari passu* provision ever – so to speak, patient zero – one might by the same token be able to unpack the logic upon which this clause rested and ultimately, come up with an interpretation of its pristine significance.[10]

Turning themselves into contract paleographers, the originalists put together search parties to ferret out the history of the true meaning of *pari passu*, in an ostensible attempt to probe whether the ratable interpretation had historical foundations. Some associated with economic historians and set out to examine classic company law treatises and collections of historical sovereign debt prospectuses. But whatever had been their original hopes, they came back empty handed. While they were able to trace *pari passu* language all the way to 19th century sovereign debt contracts, they could not make sense of the intention(s) motivating the injection of the provisions. In particular, they felt they had grounds to conclude that evidence in favor of the ratable interpretation was absent from the historical record.[11]

Before they settled on this conclusion however, historical inquiry had taken them in three directions. First, to the history of corporate loans: According to Buchheit and Pam, who pioneered the historical approach to reconstructing the descent of *pari passu* clauses, they were a transplant from Anglo-American corporate debt contracts. Classic late 19th and early 20th century legal textbooks show that corporate loans did involve *pari passu* provisions. What is more, these clauses may have implied ratable distributions, because, Buchheit and Pam (2003, p. 21) argue, they involved collateral. When collateral is pledged and one creditor seeks to recover, then the security has to be shared proportionately with other equal-ranking creditors. In such a case, a

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[8] The SDRM was shelved but this did not terminate the debate, see Hagan (2005), Krueger and Hagan (2005), Ryan (2014). It was reignited by the Greek crisis and European debt problems, see for instance Weder di Mauro and Zettlemeyer (2010) and more recently Zettlemeyer (2018).

[9] An early brief discussion of the meaning of *pari passu* clauses is Buchheit (1991).

[10] For a methodological discussion of "contract paleontology" is Buchheit and Pam (2003, p. 37).

[11] For the simile between "contract originalists" and "Indiana Joneses" see Weidemaier (2014). Buchheit and Pam (2003, p. 37) speak of contract paleontology.

pari passu clause prevents a run on the collateral, coordinating repossession. And to be sure, as the authors note, some late 19th century sovereign debt contracts did provide collateral.[12]

However, and this is, Buchheit and Pam emphasize, where problems begin, collateral in sovereign debt, cannot not imply ratable distributions in the same way it does for corporate, because under absolute sovereign immunity as prevailed at the time, repossession of the collateral was not possible in general. Writing about the 1930s, Coleman (1936) has spoken of sovereign debt collateral providing only a "phantom" security. The same applies to the 19th century: Courts ruled against creditors in the rare instance in which they sought to repossess collateral. In fact, more often than not, no real efforts were made in practice to try and seize the collateral described in sovereign debt contracts.[13] And so, Buchheit and Pam conclude, the ratable interpretation of *pari passu* provisions cannot be valid in general in the historical sovereign debt context.[14]

Second, Gulati and Scott decided to take a look at actual instances of *pari passu* clauses in historical sovereign debt covenants (Gulati and Scott 2013). With the help of Mark C. Weidemaier and students, they put together a database of sovereign debt documentation. The database is not exhaustive, especially for the early years, nor does it provide any systematic effort at sampling. The authors describe the bundle of covenants as the result of haphazardly "scouring old financial archives." Examining the language in the documents, the authors sort them out according to whether they contained *pari passu* language or not. For the period before 1919, they cull up 17 instances of *pari passu* language in a couple hundred individual contracts. As they note, for a third of those in this group there is no mention of collateral, casting doubt on the interpretation of *pari passu* as coordinating collateral repossession, already undermined by Buchheit and Pam. Gulati and Scott also identify a "patient zero", a Bolivian Bond issued in the London stock exchange in 1872 through the agency of a colorful American soldier, Colonel George Earl Church. They then discuss the context of this contract. Ultimately they report being unable to "unlock the meaning the parties attached to [this] first formulation of *pari passu*." The clause, in sum, was random.[15]

Last, Chabot and Gulati (2014) offered yet another interpretation. If one really insists on giving to *pari passu* clauses a foundation, it would have the stench of 19th century imperialism with use of the gunboat and routine human rights violations. Chabot and Gulati suggest relating the presence of *pari passu* provisions to reliance on geopolitical violence which, they claim,

[12] This on Palmer's *Company Law* and *Company Precedents* (See Palmer, 1898, 1900). See also Olivares-Caminal (2009; 2013, p. 121).
[13] The landmark decision is Smith v. Weguelin, 1869, L.R. 8 Eq. 198, p. 212-214. For a recent discussion of this and related points, see Flandreau, Pietrosanti and Schuster (2021).
[14] As one observer put it, the clauses would have had in fact "little or no meaning in the sovereign debt context." Olivares-Caminal (2013, p. 127).
[15] For this paragraph, Gulati and Scott (2013, p. 120, Table A9, and pp. 135-6).

potentially provided a way to enforce clauses in debt contracts, including *pari passu* clauses. As they put it, with the British Navy at hand, a *pari passu* clause would have had teeth "because its violation provided a justification for the gunboats to be sent in."[16] The evidence they give is the transcription of a government order in a debt covenant, in the instance an 1843 decree by Mexican President Santa Anna containing a promise to treat all creditors "equitably". As the authors claim, this decree and language would have been inspired by Santa Anna's terror at the prospect of a gunboat showing up at Veracruz. It is not exactly clear what Chabot and Gulati make of this, but they seem to suggest that, based on this evidence, the ratable interpretation of equitable treatment might hold, but only in reference to brutal imperialism, which would have been entrusted not only with enforcement of debt repayment, but with upholding equitable treatment. Were the courts of justice in Brussels and New York, as they imply in their conclusions, in league with the vultures, trying to revive gunboat diplomacy?[17]

After these musings, the contract originalists declared the matter settled. As Buchheit and Pam put it in their seminal piece: "At no time in its long journey […] did the *pari passu* clause ever require a borrower to make ratable payments to all of its equally-ranking creditors."[18] Their followers reiterated the point: Historically, *pari passu* clauses never had the meaning given in the recent court decisions, or they had this meaning but for wholly different instruments such as corporate bonds, or under radically different geopolitical, legal and ethical assumptions. Finally, driving the point home, Weidemaier, Gulati and Scott claimed to have used "history" as an instrument to debunk what they characterize as "origin myths" propagated by modern lawyers. They affirm having sorted out the problem of the true origins of *pari passu* clauses, which is that they were but a glitch replicated by rote. Modern lawyers ascribing some ancient role to the *pari passu* clause would "have it wrong." In fact, *pari passu* clauses were nothing but an accidental mutation. It produced a virus which, having jumped species propagated from whence: And the propagation mechanism relied upon the infernal mechanics of boilerplate contracts harnessed by big law firms.[19]

And yet, there are other logics to pursue. In fact, as I am going to show, when they pronounced the treasure hunt to be over, our contract archeologists had barely scooped a spoonful of sand. And given the state in which they left the archaeological site, one wonders whether they were concerned with reconstructing or instead covering it up. A more careful and comprehensive excavation, one conducted with more adequate tools, reaches into deeper and more interesting veins, ultimately providing a completely different account of the descent of *pari passu*. The new account in the present article permits us to finally understand the historical emergence of the

[16] Chabot and Gulati (2014, p. 30).
[17] In fact, the argument is from Ahmed, Alfaro, and Maurer (2010) who suggest a functional equivalence between historical gunboats and modern courts of justices under limited sovereign immunity. Weidemaier (2010) makes a related point.
[18] Buchheit and Pam (2003, p. 35); For a summary of this view, see Olivares-Caminal (2013).
[19] Weidemaier, Scott, and Gulati (2013).

clauses and in particular, to discover their crucial role in sustaining sovereign debt bankruptcy workouts, *which they did by facilitating creditor cooperation*. What is more, this account enables us to explain the partial finds of predecessors. As I demonstrate, *pari passu* clauses in sovereign debt contracts were not the misguided product of some confounded transplant from late 19th century Anglo-American corporate law. Instead, their descent in modern sovereign debt contracts proceeds from a lost and fascinating history of sovereign bankruptcy.

The starting point is the discovery of a fully-fledged sovereign bankruptcy tribunal, a transplant of the Lex Mercatoria to the field of sovereign debt, the committee of the London stock exchange.[20] This was a specialized tribunal, in fact a merchant court of justice. It was originally born – before the stock exchange started busying itself with sovereign debt and discharges – from the need to design a formal mechanism to administer *stockbroker bankruptcies*. The creation of a dedicated court of bankruptcy became necessary because, owing to the extra-legal character of the instruments that were traded in the London stock exchange, such as forward contracts which were forbidden by an English statute, the law of the land could not handle stockbroker failures properly. As a result, the stock exchange developed its own parallel jurisdiction outside the remit of bankruptcy courts – the stock exchange committee – and brand of bankruptcy law – the law and custom of the stock exchange. Under this law *failure to provide ratable distributions created a right to litigate discharges*. Creditors receiving preferred payment could be sued by others. Under threat of seeing membership rescinded, they would have to return any surplus into the creditor pool. When this stockbroker tribunal was turned into a sovereign debt tribunal in 1827, the jurisprudence – including the ratable logic which governed stockbroker default – was incorporated into the law and custom of sovereign default.

This undermines the case of contract originalists. First, unlike what has been suggested by Buchheit and Pam for instance, the presence of enforceable collateral is not a necessary condition to motivate the ratable interpretation of *pari passu* clauses. In fact, casting the whole problem in terms of sovereign bankruptcy and discharge provides a more compelling theoretical alternative – which happens to be also the historically relevant one. Let me explain: In a bankruptcy, creditors ranking equally are entered with identical rights and privileges. Their claims are charged against the estate of the defaulter in *proportion to the rights, that is ratably*. This occurs regardless of whether the payment takes place in cash or through conversion in a new loan, or via distribution of new rights and privileges. Against this backdrop, abiding by proportional distributions becomes an absolute pre-condition for successful default resolution: A contrario, stifled creditors are entitled to seize the bankruptcy jurisdiction and oppose the discharge and write-off. To put it in another way, it is hard to conceive of a successful bankruptcy regime that would set its head against the ratable logic, because departures from ratable distributions amount to an act of default. In a way therefore, what contract originalists

[20] On the modus operandi of the stock exchange sovereign debt tribunal, the reference work is (Flandreau 2013). On Lex Mercatoria and British common law, discussed more extensively later, see Kadens (2012).

have been really arguing is that there can never be a sovereign bankruptcy regime or at least, in a more generous interpretation of their thinking, that such a regime has never existed.

Against this backdrop, one way to cast the main contribution of the present article is to say that it offers to place modern debates on *pari passu* clauses in their proper context, which is that of the history and theory of sovereign bankruptcy. As just said, this history is unknown to the modern literature. For historical origins, modern authors typically content themselves with the famous lines from the final chapter of the *Wealth of Nations* where Adam Smith urged sovereign defaulters to be "fair, open, and avowed."[21] Travelling from there, and with no serious discussion of what happened in between, sovereign bankruptcy suddenly emerges in the classic article by Oechsli (1981) as a new idea, a transplant from corporate bankruptcy. It has been cast hereafter as a "Chapter 11 for Sovereigns," a reference to the section of the U.S. Bankruptcy Act dealing with corporations. The simile then reappears in several significant contributions, in particular Sachs (1987, 2002, 2003), Cohen (1989), eventually serving as background for Anne O. Krueger's blueprint for an IMF-sponsored sovereign bankruptcy procedure.[22] Yet, long before Oechsli, Sachs and Krueger, there did exist a sovereign debt tribunal entrusted with the responsibility to oversee sovereign debt discharges.[23] In many respects this tribunal, with its promotion of collective action through equal and fair treatment conditions, anticipated the innovative features at the heart of the IMF proposal, including reliance on majority decision, a focus on cooperation and the provision of a legal venue to adjust differences among creditors and between creditors and debtors.

As a result, the present article provides a historically grounded alternative to conventional ways of thinking about sovereign debt tribunals. As indicated, the sovereign bankruptcy law of the London stock exchange was a transplant, but not of corporate law. It drew on a quaint body of merchant law, the law of stockbroker failures. This may sound bizarre but in fact, it was a logical development: The law of stockbroker bankruptcy had developed as a specialty rendered necessary by the fact that derivative contracts were forbidden under British law, so that they could not be enforced in British courts. But sovereign debts found themselves in a similar position, because sovereign immunity stood in the way of contractual enforcement. The same problem called for the same remedy, explaining the filiation between the two forms of bankruptcy and why the stock exchange committee, which had been put together to handle the first situation ended up providing a venue for the second. And so, when the London stock

[21] See Smith (1776, Book V, Chapter III); Malagardis (1990) for study illustrating the narrow limits of conventional knowledge on historical origins of sovereign bankruptcy. Previous historical research has mentioned neither the legal function performed by the London stock exchange committee, nor the existence of a formal discharge system. See e.g. Suter & Stamm (1992). For economist perspectives, see also Sachs (2002, p. 1; 2003, p. 73); Rogoff and Zettelmeyer (2002, p. 471); Pettifor (2002); See also the influential survey by Panizza et al. (2009).
[22] See also Schwarcz (2000), Tirole, (2002), Bolton and Skeel (2006). See also Buckley (2009). A few authors have suggested parallels with other types of bankruptcy law. For a parallel with Chapter 9 (municipal bankruptcy), see Raffer (1990); For a parallel with consumer debt, see Block-Lieb and Weidemaier (2019).
[23] Sachs (1987); Krueger (2002).

exchange was confronted with a sovereign debt crash in early 1826, the law of stockbroker failures came in handy to inform the creation of an emergent law of sovereign default. This was how the committee of the London stock exchange became a court of sovereign debt bankruptcy.

Being at bottom a voluntary mechanism, stock exchange's sovereign bankruptcy law had limited power to compel defaulters. *But it could create rules that would help identify valid settlements*. Accordingly, the 1827 statute paving the way for sovereign discharges detailed the terms under which the stock exchange committee would ratify such a settlement. To be valid it had to be "satisfactory", which meant that it had to be assented to by a majority of creditors, who were also bound through the jurisprudence of the stock exchange to fairness rules with respect to one another: In other words, the condition for satisfactory discharges was that they would not have an exploitive character. As was the case for stockbroker bankruptcies, debts were understood to enjoy by default equal rank, so that creditors would be entitled to "ratable" distributions. A consequence of this, to which I will return in detail, is that it was not always necessary to re-specify the clause in the covenant, since it was supposed to obtain under the statute and jurisprudence: From there, a tendency for the *pari passu* clause to play hide-and-seek with the historian. But crucially, if such distributions were not forthcoming in practice, then any aggrieved party would be able to abort the discharge through litigation (if the grievance was found to have merit). The mechanism thus placed *pari passu* provisions at the very heart of sovereign debt bankruptcy workouts.

The distinctive flavor of the practice of sovereign bankruptcy at the London stock exchange committee emerged from the resulting cooperative logic. In seeking to coordinate sovereign debt discharges, the stock exchange strove to penalize uncooperative behavior. While this achieved the objective of securing a high degree of coordination (and rendered the market attractive because it was the only one that offered such powerful instruments) it also delivered significant flexibility, favoring consensual workouts and rewarding pragmatism. The approach stood out compared to the rigid standards prevailing in contemporary corporate bankruptcy, still governed by early 18th century statutes favoring coercion, strict formality, and requesting near unanimity before the court system would ratify any discharge. In fact, sovereign bankruptcy as it emerged in the London stock exchange after 1827 forged an original pathway to financial resurrection. It was not at all in the tow of corporate law, but located at the *avant-garde*. This is ironic, in view of the conventional attitude to imagine that at the beginning was corporate law and think of sovereign debt law as recent.[24]

Beyond pioneering a totally novel archaeology of *pari passu* clauses, this article also casts light on some of the "riddles" which have been discussed in the previous literature. In fact, ability to

[24] On the role of cooperation in sustaining contractual enforcement, classic references include Greif (1992) and Greif, Milgrom & Weingast (1994). For a theoretical framework on the cooperative management of public goods, see Ostrom (1990).

make sense of unsolved puzzles presents an acid test of the superior explanatory power of the sovereign bankruptcy-based theory of *pari passu* proposed here. As I will show, discovery of a full-fledged sovereign discharge template elucidates two main findings of contract paleontologists. I will show first that the language in Mexican President Santa Anna's decree providing for creditor equitable treatment was very banal at the time. Although contract originalists brandished the Santa Anna's decree as a major discovery, entire shelves of the sovereign debt museum could be filled up with similar artifacts. In fact, Santa Anna and other leaders using this language were not trying to deflect a British military landing. They were signaling that they understood that attempting an inequitable debt restructuring was futile because it would be litigated by those it would penalize. In other words, the detour through the gunboat is not needed at all to make sense of *pari passu* clauses. Under my alternative interpretation, what policy makers such as Santa Anna (and he was not alone) had in mind was not the elusive British Man-of-War but more tangible litigation before the London stock exchange tribunal and an aborted discharge.

Second, the article will show, that unlike what Gulati and Scott have argued, it is totally possible to make sense of equitable treatment provisions in the Bolivian loan of 1872. Clauses are written down in contracts because they are valuable and they are valuable, in particular, because they can be enforced. And so it is that the clauses in question were written with reference to the law of the stock exchange, a court of justice which stood to enforce them. Although ignored by modern contract originalists, this body of law was well-known to the group of financiers who contracted sovereign loans and to the lawyers who drafted the contracts – including major contemporary law firms which still exist today. I will show that in the Bolivian instance, which I will tie to previous sovereign debt contract and stock exchange litigation involving a Peruvian loan, the clauses served to deflect the risk that current creditors obstruct a future capital call. This is far from the story of random boilerplates lifted from corporate law by inept lawyers. We are in a world where sophisticated operators, fully conversant in the law of the stock exchange, were responsible for the injection of the *pari passu* language, because they realized it was a potent instrument to ensure creditor coordination.

To summarize, it is simply not true to say, as previous contract originalists have done, that nowhere in the history of sovereign debt was a *pari passu* clause ever meant to imply ratable distributions or that, as Weidemaier (2014, p. 257) put it, "the historical record remains murky as to original purpose of the *pari passu* clause, but the available [historical] evidence undercuts the Second Circuit's interpretation [in NML Capital v. Republic of Argentina]."[25] In fact, the available historical evidence underwrites cuts the Second Circuit's interpretation. Historically, ratable distributions were at the root of the entire sovereign discharge system operated by the

[25] He continues like this: "As the court interpreted and enforced it, the *pari passu* clause grants each bondholder a unilateral right to block payments to bondholders who assent to a government's restructuring proposal. To my knowledge, such a right has no precedent whatsoever."

London stock exchange. Their violation put to work the legal machinery and secured creditor coordination. Of course, I am not saying that modern courts of justice upholding the ratable interpretation were *aware* of the historical precedent since the originalists, who examined the matter were not. Nor am I arguing, in the ambitious but nonetheless circumscribed remit of this article, that the verdicts were desirable. What I am saying is that, given that the originalists have advocated the use of history, then it is relevant to emphasize using their language that they "got it wrong," and that a more careful historical investigation leads to a conclusion that is diametrically opposite to the one they proposed. Moreover, the originalists have insisted on bringing the dispute before the tribunal of history: This particular tribunal rules against them.

The remainder of the paper is organized as follows:

Part II engages with four possible explanations why modern scholars have failed to realize that a fully functioning sovereign bankruptcy regime operated after 1827. All are plausible explanations but the most compelling is that influential Anglo-American theoreticians of international law from the 19th to the mid-20th centuries argued that there could not exist such a thing as "national bankruptcy." This belief was itself tied to their theoretical understanding of the underpinnings of absolute sovereign immunity – that a sovereign could not be compelled to appear before the court of justice of another sovereign. This led them to provincialize and ultimately gloss over the role the London stock exchange as a sovereign debt tribunal even when they were aware of it. The end result was that, when modern contract originalists undertook their *pari passu* treasure hunt, they went in the wrong direction.

Part III provides a primary source-based account of the genesis of the sovereign discharge process operated by the committee of the London stock exchange. I begin with the creation of the stock exchange committee as a bankruptcy court for stockbrokers in 1798. I discuss in particular Levien v. Nisbett, an early verdict that demonstrates the equivalence between equal rights and ratable distributions in the context of bankruptcy. I end with the transplant of this original body of jurisprudence to sovereign default after 1827.

Part IV discusses the law and economics of the sovereign bankruptcy regime promoted by the stock exchange committee. In particular, it is argued that, because the sovereign bankruptcy law of the London stock exchange was focused on sanctioning sovereign debt restructurings and discharges, it was compelled to busy itself with managing creditor priorities. If a debt restructuring stifled the rights of a creditor or group of creditors, grounds were created for obstruction and this invited the concomitant development of a jurisprudence to clarify rights and hierarchies. Clarification of priorities also fulfilled a vital economic function, as it helped sustained creditor cooperation. In particular, defaulters realized that it was futile to try and collude with individual classes of creditors at the expense of others, as this would never provide them with a stock exchange sanctioned discharge.

Finally, Part V discusses the descent of *pari passu* clauses in sovereign debt contracts. Zooming in on the instances discussed in the modern literature, but also bringing up precedents which it missed, I show that the writing of equitability clauses in sovereign debt contracts was promoted by a group of super-informed contract drafters who sought to avail themselves of the strategic possibilities offered by the sovereign debt law of the stock exchange. The evidence takes care of the originalist charge that *pari passu* clauses in sovereign debt contracts were a transplant from corporate law, and of the suggestions that they were a random phenomenon.

In Part VI ends with conclusions. I discuss implications of the approach pioneered in this article, offering a diagnosis of the originalist take and emphasizing the place of the law of sovereign default of the London stock exchange in the long history of sovereign bankruptcy.

PART II. HOW (AND WHY) SOVEREIGN BANKRUPTCY WAS LOST

The starting point of my discussion is the observation that, when they began trying to look for historical origins of *pari passu* clauses in sovereign debt contracts, critics of the ratable interpretation never made any mention of the existence of a sovereign debt tribunal where violations could be litigated. This is troubling, not least because the work of Flandreau (2013), which is known to contract originalists and occasionally quoted by them, emphasizes the importance of the London stock exchange committee as a sovereign debt legal venue, and begins to unpack (though with much less detail than is done here) what it describes as the Collective Action Clause features of loans issued under the jurisdiction of the London stock exchange.[26] And so the first question to consider is, how could distinguished scholars have missed the elephant in the room? Four related explanations conspired to distract researchers.

a) A Case of Sloppy Research?

The first and the most obvious reason is that the modern historical literature is largely shaped (read: distorted) by the classic work of Edwin M. Borchard and William M. Wynne, two influential Yale Law School academics who researched the subject of sovereign default and foreign bondholders in the early 1930s and produced an influential synthesis afterward. Their work is considered to be the main historical reference for the 19th and 20th century experience. They completely ignore the existence of the London stock exchange committee as court of

[26] For instance, Flandreau's contribution is discussed in Weidemaier & Gulati (2017), which subsequently appeared as contribution to the *Oxford Dictionary of Law and Economics* under the title "International Finance and Sovereign Debt."

arbitration, the result being that subsequent research has concluded that no such thing as a discharge system could exist.

To understand the oversight by Borchard and Wynne, it is useful to consider the context in which their agenda developed. Against the backdrop of the collapse of the foreign debt market whose bulk had, by that time, migrated from London to New York, Yale University received a grant from the Carnegie Corporation to "study of the history of governmental defaults to determine empirically the principles, legal or customary, if any, upon which the adjustment of these varying claims, in relation to one another, may be determined."[27] The result was the landmark article by Borchard and Wynne, "Foreign Bondholders Protective Organizations" by the *Yale Law Journal* (Borchard and Wynne 1933). It made its way subsequently, word for word, in the famous two volumes summa, *State Insolvency and Foreign Bondholders* (Borchard 1951; Wynne 1951).

At the time when they undertook their explorations, severe archival limitations constrained the two scholars. The archives of the London stock exchange, which is indispensable if one wants to reconstruct the law of bankruptcy that was cultivated there, were not yet open to the public. According to the archivists, the Stock Exchange papers were transferred to the Guildhall circa 1974/5 on the disbanding of the Stock Exchange Library. Next, they were kept there on deposit and then in 1995 held as a gift now under the authority of the London Metropolitan Archive.[28] Note that there is no evidence that Borchard and Wynne tried to secure access. In fact, as their writings demonstrate, they were not aware of the *legal* role played by the stock exchange committee and so a fortiori of its role in bankruptcies. They understood the function fulfilled by the stock exchange as administrative and regulatory. Indeed, they noted that the "stock exchange" had the authority to prevent issues from a sovereign borrower if it determined the country was a defaulter, but viewed such decision as a mere listing requirement. As a result, the two lawyers missed out the judicial process underlying the decision to grant or refuse listing. A fortiori, they totally missed the fact that a country authorized to issue following default was given a clean slate: In fact, it was *granted a discharge*.

Borchard and Wynne's implicit belief that the stock exchange determining the standing of a defaulter was a straightforward matter is surprising because of course, as any sovereign debt lawyer will recognize, nothing is more difficult than setting a criterion for sovereign bankruptcy. But it appears that Borchard and Wynne were principally interested in bondholder organizational responses to default and how they fared. This led them to focus almost exclusively on the British Corporation of Foreign Bondholders (CFB), which had been launched in 1868 as a "Council" and incorporated 1873 as a non-profit regulated by the Board of Trade and was still at the time of their investigation the official representative of British foreign bondholders. Borchard and

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[27] Borchard and Wynne (1933, p. 282, n. 6).
[28] I am grateful to Jeanie Smith from the Guildhall Library to have clarified this point for me.

Wynne went to London to meet with senior officials of the CFB, secretary Douglas Reid and assistant secretary A.L. Philp.[29]

As appears from their account, the British gentlemen served their visitors a well-oiled corporate pitch that, all the way to the creation of the CFB's cartel, bondholder representation had been plagued by rampant coordination failures. As they burnished the shield of their employer, the British interviewees logically glossed over the coordination function fulfilled by the tribunal of the London stock exchange. In fact, not a shred of evidence was provided in support of their narrative. The story of the CFB as a white knight of sovereign debt had been distilled in promotional material when the CFB had been launched, and could be found in press articles conveniently organized in a folder kept in the archive of the CFB, which Borchard and Wynne probably saw. But as demonstrated by the same archive, these were essentially publicity statements, in fact paid for by the CFB.[30] Borchard and Wynne were also directed to the works of the architect and first spokesperson of the CFB, a man named Isidore Gerstenberg, whose pamphlets they examined at the British Museum. Gerstenberg had suggested, among other things, that previous bondholder organizations had lacked continuity, formality and especially coordination, obstacles that had stood in the way of their ability to project power, but which his brainchild would remedy.[31]

The result was the often-quoted paragraph in the professors' classic 1933 article that until the advent of the CFB, bondholders would have had "no recognized means of organization for the protection of their interests." Clearly demonstrating the authors' ignorance of the functions and powers of the London stock exchange, and in particular, of its ability to manage creditor hierarchies, they asserted that bondholder groups were either "self-constituted or appointed by an informal meeting of holders of bonds which had gone into default." Having said that, Borchard and Wynne felt right to conclude that against such a backdrop, "the need for such an organization [as the CFB] was apparent."[32] Yet had Borchard and Wynne done more than scratched the surface, they would have made a few surprising discoveries. They would have found for instance that Gerstenberg, a veteran sovereign debt activist himself, was fully conversant in the legal procedures of the stock exchange committee, which he had repeatedly

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[29] Borchard and Wynne (1933, p. 289); They also spent time at the library of the British Museum.
[30] The press cuttings were collated in a folder entitled "Extracts Relating to the Establishment of the Corporation of Foreign Bondholders." Archive CFB, LMA. For payments to the media, see Archive CFB, LMA, MS 15751, 1, p. 198.
[31] See Borchard and Wynne (p. 285, n. 13). Gerstenberg (1868: Suggestions, p. 12, 10).
[32] See Borchard and Wynne (1933, p. 285), repeated in Borchard (1951, p. 203). The complete quote goes like this: "Prior to the establishment of the Corporation of Foreign Bondholders, British holders of foreign bonds (and the same was, of course, true at that time of the relatively few bondholders of other nationalities) had no recognized means of organization for the protection of their interests. They were in many instances represented by committees which were either self-constituted or appointed by an informal meeting of holders of bonds which had gone into default; but there was in existence no institution whose object it was to represent the interests of the holders of foreign bonds in general, to represent their claims to the British Government, and to negotiate terms for the settlement of the default and the resumption of payment."

and successfully mobilized to assist his interventions on behalf of the bondholder committees he chaired. What is more, they would have come to realize that, far from being depopulated, the bondholder representation scene was vibrant. One influential predecessor of the CFB was the Spanish American Bondholder Association, which not only controlled most Spanish American debt restructurings but expanded its market share beyond this, in fact *across* constituencies, so that pending a more systematic examination of the data which I am currently completing, the story of the bondholder chaos is disputable at best. In fact, CFB insiders would later argue that the CSBA was really the predecessor of the CFB.[33] Had Borchard and Wynne pondered such evidence, they might have been led to ask why it was so. This might have taken them to the law of the London stock exchange, the system's deus ex machina which helped coordinate creditors. But they did not and the result was the account left behind, which continues to lure researchers off the scent.

b) A Case of Political Priors

Why did Borchard and Wynne offer so little resistance to the myth they were presented with? In part, the answer has to do with political priors affected by the ambiance of the time. After emphasizing the role of the CFB as a mean to provide for creditor cooperation, the two CFB employees had also emphasized a second aspect of the organization, namely its "public good" dimension. Since its inception in 1873, the CFB had been a non-profit organization and what is more, its governance had been subsequently reformed to deflect perceived risks of greedy interventions from underwriters, who were suspected of being too soft with defaulters, since they collected fees from debt issues. As a result, they would have been poor stewards of the interests of creditors.[34] This argument worked really well on the two American scholars, who shared contemporary skepticism of the unfettered market's ability to discipline itself. In the reading Borchard and Wynne offered, the unregulated defense of bondholder committees was bound to fail, succumbing to free riding, and as a result it had to be tightly regulated.

As said, the work of Borchard and Wynne occurred against the backdrop of the international debt crisis that erupted in the Summer of 1931, on the heels of the sterling crisis. The ensuing debacle of foreign loans issued in New York during the 1920s led to the famous Hearings on the Sale of Foreign Bonds conducted by the US Senate Finance Committee. The financiers who had originated now depressed securities were grilled by US Senators led by Hiram Johnston, a Republican Progressive from California.[35] The dominant perception, echoed by the media was

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[33] Bishop (1901); Flandreau (2016, p. 266-7).
[34] See Flandreau and Flores (2012) for a discussion of this point.
[35] U.S. Congress, Senate (1932). Classic sources on the interwar sovereign debt crisis and the policy response include S.E.C. (1937); Lewis (1938); Mintz (1951) and Stallings (1987); For an analysis of the macroeconomic context of the crisis see Eichengreen and Portes (1986); For repayment rates see Eichengreen and Werley (1988); Huertas and Silverman (1986) and Flandreau, Gaillard and Panizza (2010) for a critical assessment of contemporary charges of "banksterism;" Chernow (1990) and Flandreau (2017) for analysis of regulatory reform emphasizing the showdown between FDR and the House of Morgan.

that "international bankers" had succumbed to greed. They had levied fat fees and left "Tom, Dick and Harry" hold the bag. Only a few months after the crash, in his famous speech in Columbus, Ohio, presidential candidate F.D. Roosevelt declared war on international bankers whose culpability was obvious "in view of the huge banking commissions which were being made out of [international] loans." The same speech pledged to secure the protection of the investing public.[36] After he was elected, FDR followed up in his first inaugural address with his famous lines on the modern money changers who had "fled from their high seats in the temple of our civilization" and the need to "apply social values more noble than mere monetary profit."[37] The New Deal, and in particular the reformation of Wall Street through successive Securities Acts, would implement the logic, whereby principle trumped expediency. Against this backdrop, it is easy to understand why engaging in a demanding archival exercise on the antecedents of creditor organizations in the early Victorian Era was not a New Deal policy maker priority.

This context had an enormous bearing on the work of Borchard and Wynne. Because of it, sovereign default came to be understood, not through the lenses of bankruptcy law, but as a part of a regulatory agenda geared towards the protection of creditors. The problem to be addressed was intermediaries' conflicts of interests. The attitude shaped decisively the American variant of the CFB, the Foreign Bondholders Protective Council (FBPC), brought to life under Title II of the Securities Act of 1933. In order to fulfill "the purpose of protecting, conserving and advancing the interests of the holders of foreign securities in default" the FBPC sought to minimize perceived conflicts of interest. First, the FBPC was incorporated as a non-profit. Second, anyone "who within the five years preceding has had any interest, direct or indirect, in any corporation, company, partnership, bank or association which has sold, or offered for sale any foreign securities" was excluded from its Board of Directors.[38] Third, while formally private, the FBPC was really under the control of the newly created Securities and Exchange Commission, which had authority over new listings in the New York stock exchange. Administrative oversight of foreign loans was further consolidated by the Johnson Act of 1934, which forbade the selling of any new loan to defaulters.[39]

This was how the fragile case submitted by the two CFB employees to the two American lawyers became received wisdom: It had been gist to the American mill of the time. But as it passed into scholarship, the slovenly research paper began to shape subsequent understandings. When the Latin American debt crisis hit in the 1980s, scholars were discouraged by the work of Borchard and Wynne from looking more carefully into the actual historical record, which would have been

[36] August 20, 1932; See Roosevelt (1937, p. 673).
[37] March 4, 1933; See Roosevelt (1938, p. 12).
[38] Winkler (1933: 174).
[39] On the early operation of the FBPC, see Adamson, (2002), p. 487-8. For a discussion of the political economy of the reform, see Flandreau (2017). See Securities Exchange Commission (s.d.) provide an excellent account of the "imperial" role of the SEC with respect to foreign loans. A useful document illustrating the reach of the ideas in Borchard and Wynne among New Dealers is the Securities and Exchange Commission report on "Protective Committees and Agencies for Holders of Defaulted Foreign Governmental Bonds", in SEC (1937, p. V).

possible because by that time, the archive of the stock exchange had become fully available. They read, once again, the British experience through the lens of the conflicted account given in the offices of the CFB in 1933 especially, and missed the court of bankruptcy. There is an element of irony in this, since the experience of the London stock exchange, and in particular the manner in which it sanctioned sovereign debt write-offs would have been spot on.

One additional factor explaining the facility with which the account by Borchard and Wynne was absorbed is that the view they offered could be easily assimilated in the language of then popular game theoretical approaches to policy making.[40] In one influential contribution, Barry Eichengreen and Richard Portes mobilized the language of game theory to rationalize the claims in Borchard and Wynne. In their reading, creditor free riding was destiny, a "notorious" outcome: They wrote for instance about how "rivalry among competing committees undermined the credibility of each." (Eichengreen and Portes (1986, p. 622). In sum, what Borchard and Wynne had written was accepted uncritically, because it supported the new generation's preferred models. And so, against this backdrop, modern proponents of sovereign debt write-offs such as Oechsli or Sachs were led to suggest that their proposal found its roots in the abstract economic lessons from modern corporate bankruptcy, rather than in an actual history and practice of sovereign default and discharge. In the end, if we got the London Club, it was out of common sense, not out of enlightened knowledge of the past.

The attitude has lingered: A more recent IMF position paper on the subject of historical bondholder organizations published a few years after the Krueger proposal aborted, returns once again to the case of the creation of the Corporation of Foreign Bondholders in 1873 and working from second hand sources, repeats the old mantra, entirely missing out the early existence of the sovereign debt tribunal (Mauro and Yafeh 2006). Once again, the authors argue that the creation of the CFB arose from the "need for creditor coordination."[41] Subsequent exhortations by Flandreau (2013) that scholars interested in sovereign debt should take seriously the law of the London stock exchange fell on deaf ears. In the end, the opportunity to (re)discover the legal functions fulfilled by the London stock exchange in the realm of sovereign debt and default was forfeited. As for the research of contract paleographers, it did inherit the ignorance of facts. This was how they failed to suspect that originally, clauses in sovereign debt contracts were introduced with an actual tribunal in mind.[42]

[40] See e.g. Aggarwal (1996) for a later synthesis.
[41] Mauro and Yafeh 2006, p. 6; Wright (2002) for a formal rationalization of the CFB as a creditor cooperation promoting instrument.
[42] For an illustration see Weidemaier (2019), an article devoted to the law of the London stock exchange circa 1900. It does not make a single reference to the role of the committee as a stockbroker bankruptcy court and misconstrues the committee's function as merely providing a dispute resolution mechanism.

c) A Case of Legal Theory

But it would be too simple to blame the enduring ignorance on sloppy historical work and conclusions drawn in a particularly operatic atmosphere and received afterwards uncritically. The third reason I suggest for the oversight of the importance of the stock exchange bankruptcy tribunal is more elevated. I argue that the neglect is rooted in a radical conception of sovereignty which peaked in the 19th century and first half of the 20th century, especially in the Anglo-American tradition. According to this view, sovereign default cannot be dealt with by the courts of justice of the creditor country.[43] In the reading it inspired, sovereign default is an intergovernmental affair – a matter to be dealt with between sovereigns. The practical expression of this legal theory was the so-called sovereign immunity doctrine, according to which domestic courts of justice were not competent to hear lawsuits against foreign sovereigns defaulting on their debts. In case of default, the relevant instruments were diplomatic, not legal. But then, if courts of justice were not involved, there could not be a court of sovereign bankruptcy to begin with. That the stock exchange committee *in fact* fulfilled that function was an unwelcome complication, which, especially for British international law scholars, threatened to shatter the conceptual underpinning of the political order of which they were part. The result was a preference for obfuscating the problem, leaving the sovereign debt tribunal of the London stock exchange in a legal theory blind-spot rendering it virtually invisible.

This point requires elaboration because our knowledge of the practical evolution of ideas and conceptions about sovereign bankruptcy is extremely rudimentary. Today's scholars who promote a bankruptcy law for sovereigns often quote a brief sentence in the last chapter of Adam Smith's *Wealth of Nations*, which contains a normative statement as to how sovereign failure ought to be handled. Smith embarks on a simile where he recommends that defaulting sovereigns approach the matter in the same mode as merchants that is, in an "a fair, open, and avowed" fashion, confiding with his creditors.[44] Smith is a giant of economic science, but his take hardly represented the majority view of his time. Before Smith, John Law, another enormously influential Scottish economist had emphasized instead *differences* between public and private borrowers, suggesting that sovereignty conferred specific rights and privileges. In fact, anticipating on modern works that challenge the Chapter XI simile, Law theorized sovereign

[43] As explained later, it is particularly clear in the discussion provided by contemporary law officers, such as Phillimore (1882, esp. Vol. II), though I have also relied on other contemporary textbooks such as John Westlake (1858). See also Lienau (2014).

[44] See Smith (1776, Book V, Chapter III): "When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both the least dishonourable to the debtor, and least hurtful to the creditor." Jeffrey Sachs (2003, p. 73) builds on this quotation to claim that the effect that "the principles for a bankruptcy apply whether the debtor happens to be a sovereign or not," a reading which is shared by the vast literature which in the past half century or so, has advocated a "Chapter XI for Sovereigns" and of which the IMF/Krueger proposal may be seen as an offspring; Smith is also quoted in Malagardis (1990), Sachs (2002, p. 1) and Rogoff and Zettelmeyer (2002, p. 471).

prerogatives (he spoke of the "high domain") and the bearing they had on sovereign default which he considered legitimate even when arbitrary.[45]

Law, rather than Smith, probably represented average opinion at the time. In fact, the sui generis nature of sovereign default was emphasized in 1758 in Emer de Vattel's *Droit des Gens*. According to Vattel, sovereign default came under the law of nations. The debt a sovereign owed to foreign investors, if admitted as good, was to be enforced in case of non-payment by the sovereign of the creditor country having at her disposal the arsenal of inter-state instruments, from friendly persuasion to war.[46] As Vattel was translated into English by Joseph Chitty and absorbed into the British practice of international law through the opinions of the Law Officers who advised the British Crown on legal matters, his position was tied to the doctrine of sovereign immunity, which British courts upheld, and according to which foreign states could not be sued in England on their obligations.[47] Against this backdrop, the British sovereign had alone the right to intervene in case of default.[48] In the language used by one British judge affirming the incompetence of his court to address sovereign default: "No English court has jurisdiction to entertain any complaints against [the foreign potentate] in that capacity. Redress for such complaints affecting a British subject is only to be obtained by the laws and tribunals of the country which the foreign potentate rules, or by the representations, remonstrances or acts of the British Government."[49]

This conception had, in fact, political foundations. The argument ran as follows: The British sovereign was in amity with other sovereigns. Accordingly, British tribunals did not possess the right to interfere with them. Courts, under the authority of the Lord Chancellor, did not have any right to topple this harmony. If they claimed to be themselves competent to adjudicate a dispute between foreign defaulters and their British creditors, courts would inevitably run the risk of delivering a verdict against the foreign state. Enforcing it, would require an act of war. By right a member of the British Cabinet, the Lord Chancellor would usurp the prerogatives of the

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[45] See Law (1790, p. 164, n. 1) and in particular Law (1934, pp. 353-354), speaking of the ancient custom of "Jubilee" mentioned in the Leviticus (25.8-22); For a classic treatment of Law's views, see Faure (1977, p. 237). For a more recent perspective, see Orain (2018).
[46] Vattel (1758), 1. ii. 0. xiv. s. 216.
[47] Compare with Pitts (2018) who argues that Vattel falls out of favor as the canonical text for the Law Officers around the Opium Wars. It is clear from subsequent quotations and mark of approval by influential law officers such as Phillimore that he was not disposed of altogether, especially not regarding immunity doctrines as applying to sovereign debt, especially regarding the role of sovereign peer pressure as instrument for resolution.
[48] See Westlake (1858, p. 226): "Foreign states, and those persons in them who are called sovereigns, whether their title be emperor, king, grand-duke, or any other, and whether their power in their states be absolute or limited, cannot be sued in England on their obligations." The most important verdict by the frequency with which it was quoted when courts declared themselves unable to help the bondholders was Duke of Brunswick v King of Hanover. Though it did not involve sovereign debt, it raised in the clearest fashion the problem of the competence of British courts vis-à-vis foreign sovereigns. The Brunswick decision was highly authoritative most probably because it had resulted in a unanimous decision in an ultimate appeal before the House of Lords in July 1848 (Duke of Brunswick v King of Hanover, 9 E.R. 993, 1848).
[49] Opinion of Lord Campbell C.J. in de Haber v Queen of Portugal (1851) 17 Queen's Bench Reports 196, p. 1259.

Secretary of War and of the British sovereign altogether. The logic was further spelled out when creditors nonetheless did test courts' resolve to adhere to the doctrine. In one lengthy opinion, the Master of Rolls explained that, had he complied with the plaintiffs request to return a verdict against a sovereign, the court "would fall into this dilemma: Either it would simply make itself ridiculous in attempting what is impossible, or if it could assume that the foreign Government was answerable to this Court, and bound to pay according to its decrees, and then […] *it might alter the relation between the two countries, and enable a bondholder by the aid of the Court of Chancery practically to declare war against a foreign country*."[50]

Against this backdrop, sovereign bankruptcy could only be an absurdity. In fact, this was the opinion of Robert Phillimore, an influential international lawyer who, as Law Officer himself, was repeatedly asked to return opinions in sovereign debt cases and was also solicited by bondholders.[51] In an opinion returned in 1859 for a committee of Spanish bondholders, he came down on the concept of sovereign bankruptcy, or as he put it the "plea of National Bankruptcy." A country making such a plea – declaring itself a bankrupt – would be "a defense wholly novel in the history of the intercourse of European Nations." The reason was, bankruptcy had coercive features which could simply not be operationalized with sovereign debt because of sovereign immunity. For instance, "the Bankrupt State, like the bankrupt individual, must deliver up all its assets so that they may be equitably apportioned among the Creditors." But this was impossible to perform. Clearly the concept of bankruptcy (which we note in passing, in Phillimore's mind, would have required ratable distributions) was preposterous because delivering up *sovereign assets was impossible in the first place*: In short, either there could not be sovereign bankruptcy, or there could not be sovereignty. Phillimore summed the argument by stating that national bankruptcy was "both on principle and by usage—the two foundations of international law—inadmissible."[52]

The higher echelons of the British legal establishment conceived of themselves as custodians of the doctrine of sovereign immunity. They saw to it that lower and marginal judiciary echelons would fall into line. This is demonstrated for instance by the episode of an attempted use of a lower jurisdiction to secure recovery in the early 1850s. The tool was "foreign attachment," an old law merchant instrument under the Court of the Mayor of London enabling creditors of a private foreign defaulter to garnish the assets held with a defaulter's correspondent. All that was needed was to locate the London correspondent and apply to the Lord Mayor's Court, which would serve the notice. In 1850, creditors of Portugal and Spain, two sovereign defaulters, identified the countries' correspondent in the City and approached the Court of the Lord Mayor, which served the notices. However, the garnishees appealed to Queen's Bench, which rescinded the orders immediately. As the judge who reviewed the Portuguese appeal put it: "What has been

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[50] Lord Romilly M.R. in Smith v Weguelin, 1869, L.R. 8 Eq. 198; at 213-4

[51] Phillimore was the author of one of the most influential 19th century British treatises of international law. For his discussion of sovereign debts and sovereign default, see Phillimore (1871, Vol II, Chapter III).

[52] Phillimore (1859 in Committee of Spanish Certificates , 1860, p. 61-2).

done in this case by the Lord Mayor's Court must be considered as peculiarly in contempt of the Crown, it being an insult to an independent Sovereign, giving that Sovereign just cause of complaint to the British Government, and having a tendency to bring about a misunderstanding between our own Gracious Sovereign and her ally the Queen of Portugal. [...] We think we are bound to correct the excess of jurisdiction brought to our notice, and to prohibit the Lord Mayor's Court from proceeding further in this suit."[53]

The consequence of this was that the law of sovereign bankruptcy, which came to be developed by the London stock exchange came into existence in a theoretical blind-spot, turning it, so to speak, into a clandestine institution. Unlike what had happened to the rulings of the Lord Mayor, its decisions could stand because, as will come clearer in a subsequent section, they could not be appealed as easily. This had to do with the nature of disputes brokered by the stock exchange, but also with the fact that the committee operated in what authorities considered, perhaps opportunistically, to be a legal no-man's-land. The result was that the sovereign bankruptcy law of the London stock exchange was ignored by sovereignty purists. For them it was off-limits, and as a result, it remained hidden from the sights of the Law of Nations as professed by Phillimore and successors; so well-hidden in fact, that it was forgotten.

Indeed, Phillimore's reading continued to inform subsequent dominant Anglo-American legal scholarship. Well into the 20th century, this scholarship remained a staunch supporter of his view of sovereign bankruptcy. In fact authorities such as Borchard and Wynne cringed at the notion that some kangaroo tribunal could be put in charge of making happen what considerate scholars deemed impossible. This comes out forcefully from yet another paper by Borchard, in fact a prequel to the classic article with Wynne published in 1933. Drawing on Phillimore and on other legal scholars espousing the same conceptions, Borchard states that in his own understanding, "if the state becomes insolvent or repudiates, such eventuality is a contingency which the creditor had or should have had in mind in concluding the contract or buying the bond, and that the state is as privileged to alter the terms of the contract or to violate it, as it was originally to enter upon it."[54] He then moves to a dissenting school with "diametrically opposite" views. As Borchard puts it, members of this school maintain "that a state contracts a loan under the same legal conditions as any private corporation or individual."[55] But in Borchard's depiction this view is

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[53] Wadsworth v the Queen of Spain, 1851 117 E.R. 1246 (1851); De Haber and the Queen of Portugal 1851 117 E.R. 1255 (1851).

[54] Borchard (1932, p. 143). The language from Phillimore he selects is the following: "The English courts have decided that bonds payable to bearer issued by the government of a state only create a debt in the nature of a debt of honor, which cannot be enforced by any foreign tribunal nor by any the tribunal of the borrowing state itself, unless with the consent of its government." Phillimore (1882, Vol. II, p. 18), quoted in Borchard (1932, p. 144).

[55] Borchard (1932, p. 145). As Borchard further explains, this view holds that "the obligation of the contract is to be controlled by the law of contracts; and that when foreigners are creditors, these foreigners have the protection of international law for the fulfillment of their contract. State insolvency or bankruptcy is regarded by this school as a breach of a legal obligation by the debtor state."

not solid. As he puts it, it fails to "[discuss] too fully the nature of sovereignty."[56] Had such heretics pondered the subject carefully, Borchard implies, they would have come to realize that a tribunal engaging a sovereign is an impossibility. And so, as the title of their celebrated volume reflected, Borchard and Wynne were left with insolvent states, foreign bondholders and nothing imaginable in between. They preferred to be gaslighted by the managers of the Corporation of Foreign Bondholders than reconsider this prior.

d) A Case of Semantics

The last explanation I give for the neglect of which the role of the stock exchange committee as a sovereign debt court of justice has suffered has to do with the fact that, as just mentioned, it was not *formally* part of the British legal system. This position is held for instance by Leland H. Jenks, one of the rare authors to have mentioned the legal nature of the stock exchange if only in passing. But Jenks casts doubt on the fact that the London stock exchange qualified as a proper legal venue, because it "was even devoid of status in the courts."[57] But the value of the distinction is doubtful and, in fact, the claim that the stock exchange committee was devoid of status in courts in incorrect. As G.R. Rubin and David Sugarman demonstrated in their classic volume on English law, opposing formal (public) and informal (private) sphere within the British legal ecology is not helpful because of the tight complementarities that existed between the two (Sugarman and Rubin 1984). As they show, "formal" jurisdictions helped "informal" ones either by looking away or by offering explicit support via rulings that acknowledged the existence of the "subaltern" courts. Conversely, the "subaltern" private jurisdictions provided fields of experimentation with higher courts in tow of lower court verdicts.[58] Rubin and Sugarman emphasize that the stock exchange committee offered one such legal venue. One article in the volume – by R.B. Ferguson – deals precisely with the subject. It does not engage with sovereign debt but with derivative trading in the London stock exchange, and concludes by emphasizing "how wrong it would be to postulate a blanket dependence [of contractual performance] on [traditional] legal enforceability of contracts."[59]

As my own research finds, there is indeed significant evidence of cooperation between the London stock exchange and the courts of law. This occurred, even as the stock exchange was involved in illegal activities. In fact, the bulk of trading in the market was made in forward bargains known as "time bargains" that were illegal under the Act of Barnard in 1734.[60] What

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[56] Borchard (1932, p. 145).

[57] Jenks (1927, p. 284), In fact, Jenks' discussion, influential as it has been, does contain several factual errors, suggesting incomplete familiarity with the topic; For a discussion of the flaws in Jenks exposé, see Flandreau (2013; p. 675, n. 21; p. 678).

[58] See in particular their introductory essay, "Towards a new history of law and material society in England, 1750-1914," pp. 1-123.

[59] Ferguson (1984, p. 206). Compare with Cornish, et al. (2019), whose recent synthesis of the British judiciary 1750-1950, though situating itself in the tradition of Rubin and Sugarman, is silent on the stock exchange committee.

[60] An Act to prevent the infamous Practice of Stock-Jobbing" (7 and 8 Geo. II, c. 8).

this came to mean in practice was that, if asked to enforce a derivative contract made in the stock exchange, British courts would look the other way, enabling a trader to default "legally." Furthermore, the Act provided that individuals having evidence of illegal bargains could bring so-called qui tam lawsuits, whereby the informant and the Crown would share in the fine for illegal activity. Yet in practice, courts of justice were reluctant to follow up on such denunciations: According to the counsel of the stock exchange committee speaking around 1820, British courts would not seek to examine the detail of the situation as long as everyone colluded to present as spot or "money" operations what was really illegal forward bargains.[61] And so, while there is evidence of qui tam lawsuits there is no evidence of verdicts against defendants.[62] Sustaining the moderation of courts, a theory had emerged under Lord Mansfield that forward bargains were *malum prohibitum* (wrong because forbidden) rather than *malum in se* (wrong in itself).[63]

As judges may have realized, the illegality of forward bargains created more problems than it offered solutions. In particular, the next part of this article will argue that the illegality of forward bargains turned stock exchange failures into institutional nightmares. This explains why British courts of justice did not object to the emergence of a legal venue that would busy itself with managing stock exchange defaults. It happened in 1798, when the stock exchange equipped itself with a new dedicated venue, the stock exchange committee, tasked with overseeing stockbroker bankruptcies. Consistently with the pattern observed by Rubin and Sugarman, British courts tolerated this new tribunal, especially as long as the committee, a de facto lower court, knew its place and how to stick to the subaltern position it had in the country's legal infrastructure.

This became evident almost immediately, through a succession of rulings that admitted the customary authority of the jurisdiction. In 1803 for instance, after some operators had planted false information on pretended preliminaries of peace to take advantage of price movements, the committee declared all bargains voids, whether they were "legal" spot contracts or "illegal" forward contracts. But since spot transactions could be enforced by courts of justice, some sellers eschewed the injunction of the committee and tried to have courts enforce their contracts. This resulted in a flurry of lawsuits in King's Bench. The first case, Bourdenave v. Gregory, saw the court emphasize the sui generis nature of all stock exchange contracts. They were governed by custom, which meant that the parties could not play "fast and loose" (in the language of one counsel) and consider the contract valid or not as suited them. The ruling was terse but it empowered the stock exchange committee since, at the end of the day, the contracts were not

[61] See MGPC, 14600/9, p. 67.

[62] The well-informed Anonymous (1879, 192) states that under Lord Kenyon (Lord chief Justice between Mansfield and Ellenborough), about two hundred *qui tam* lawsuits against stockbrokers would have been attempted.

[63] For the arguments in this paragraph, see Flandreau (2022). See also Taix (2018) for a similar point, playing down the extra-judicial character of illegal bargains and the complementarity of courts.

enforced. The overall discussion and verdict amounted to an indirect admission of the authority of the committee over the customs in question.[64]

On the back of decisions such as this, an oblique dialogue was building up between the stock exchange committee and British courts. A more complete account is beyond the remit of this article but it would show that the general attitude was for courts to *acclimatize* precedents established under the law and custom of the stock exchange. Summarizing the entire evolution, a high point was Goodwin v. Robarts, a case in Exchequer in 1875. The case revolved around the legal standing of "scrip" that is, stock exchange certificates of issue used in the stock exchange to trade a new instrument before the physical security was printed. Sir Alexander Cockburn C.J. ruled that he would understand scrip in the same way the stock exchange committee would – as a bona fide security. Cockburn emphasized that in the natural process of things, the law merchant (of which the law of the stock exchange was cast as a modern avatar) is "engrafted upon, or incorporated into, common law, and may thus be said to form part of it." The judge traced this attitude – which informed, he explained, his own ruling – to the approach originally championed by no less than Lord Mansfield, thus locating his own ruling in an illustrious tradition.[65] Given this, Jenks contention that the stock exchange's jurisdiction was "devoid of status in courts" is not compelling.[66]

A similar process was to occur for sovereign debt. As we saw, the theory promoted by Phillimore and other advocates of the law of nations was that there could be no national bankruptcy and that it was ultimately up to the sovereign of the creditor country to decide whether she would flex muscle and secure enforcement.[67] But the glitch was that this view clashed with the British executive's own policy objectives. As D.C.M. Platt demonstrated long ago, the main goal of Her

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[64] Bournenave v. Gregory (1803) 1 J.P.Sm. 306; See also Bordenave v. Gregory (1804) 5 East 107. The case is sometimes spelt Bordenave.

[65] Goodwin v. Robarts, (1874-75), L.R. 10 Ex. 337. This case involved the legal standing of "scrip," a stock exchange certificates of issue which was routinely used in the stock exchange. Sir Alexander Cockburn C.J. ruled that he would understand scrip in the same way the stock exchange committee.

[66] For classic discussion of the relation between the law merchant and common law see Ewart (1902), and Sutherland (1934). For a criticism on the agency conventionally ascribed to Lord Mansfield, see Kadens (2012). The extent of the process of engraftment is evident in *The Law and Customs of the Stock Exchange*, an exegesis of the law of the stock exchange by Rudolph Eyre Melsheimer, a barrister, and Walter Laurence, a stockbroker (Melsheimer and Laurence 1879). The treatise provides the rules and regulations of the stock exchange while supplementing them with copious notes referring the reader to the jurisprudence of British courts of justice, recapitulated by an intimidating cascade of cases in the opening pages of the book. At that point, the law and custom of the stock exchange committee and common law were closely entangled, inseparable.

[67] As Phillimore put it: "Neither the law nor the practice of nations leaves the subjects of States, who have contracted with the Governments of Foreign States, altogether without remedy, in the event of a breach of faith on the part of Foreign Governments." In case conciliation proved "ineffectual, it will remain for the Government of the injured subjects to take such measures in their behalf as it may deem expedient." Committee of Spanish Certificates (1860, p. 63). See also the *Commentaries*. The opening line of the chapter on foreign debts reads: "The right of interference on the part of a State, for the purpose of enforcing the performance of justice to its citizens from a foreign State, stands upon an unquestionable foundation, when the foreign State has become itself the debtor of these citizens." (Phillimore 1872, Vol. II, p. 8).

Majesty's Government was to avoid getting embroiled in disputes between bondholders and foreign governments and in particular prevent the Navy from being turned into a collection agency as this would encourage moral hazard (Platt 1968). The policy inaugurated by Canning in the midst of the foreign debt boom of the mid-1820s was cast in stone by the so-called "Palmerston circular" in 1848, a formal exposé of the British policy doctrine: Britain would simply not go to war on behalf of the bondholders.[68] The Palmerston circular created a tension between British international lawyers (the Law Officers) and British foreign policy makers, which activist bondholders sought to exploit, asking the former for an opinion which would undermine the latter's aloofness.[69] But in the end, the executive refused to surrender, the result being that the position of sovereign debt was structurally identical to that of illegal derivatives, though for different reasons: Sovereign defaults, just like stockbroker defaults, were orphaned by the British judiciary.[70]

Given this, the stock exchange's sovereign bankruptcy mechanism came to fulfill a much-needed function. It offered a venue to adjudicate debt restructurings. What is more, the tools that it developed did not clash with the authority of higher courts enabling them to adhere to their cherished sovereign immunity doctrine. It was in fact this theoretical snobbery of the courts which gave the committee a free hand, the end result being that the stock exchange law of sovereign bankruptcy could develop unperturbed. One reader asked me to drive the point home and state that the institution got to persist because the Chancellor just considered it to not be law, which would next raise, he suggested, the issue of identifying a bankruptcy institution that, for technical reasons, refuses to be called and is not called a bankruptcy institution. But this would not be a correct historical interpretation and it is certainly not my conclusion: Rather, my understanding is that until the rationalizing efforts of the Judicature Acts of 1873 and 1875 at least, the British legal system was very much an archipelago, which managed tension through fragmentation. The stock exchange's court of bankruptcy was called a tribunal by those who relied upon it. That it was not called that way in other places does not detract anything this. Or does a fig leaf remove our ability to know what it hides?[71]

What is more, this construction, "hypocritical" if one pleases, survived not so much because higher authorities did not organize a crackdown but because the fault line remained largely untested for structural reasons: Occasions for a clash between the law of the stock exchange and

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[68] As Canning had announced, "If British investors chose to risk their money overseas, it was their own funeral if they lost it." (see Ziegler, p. 106-7). See D.C.M. Platt for details (Platt 1968, "H.M. Government and the Bondholders").

[69] For a particularly illuminating example pitting against one another Venezuelan bondholders led by Gerstenberg and HM's Government see Platt (1968). The resulting dance looked like this: After Law Officers (such as R. Phillimore) returned an opinion clearing the way for the dispatch of the Navy, the Prime Minister demurred, refusing to end up hostage of the bondholders.

[70] As one contemporary observer put it, this Law of Nations approach to sovereign default was a little more than "bag of moonshine" with which bondholders could forget their sorrows; See Anonymous (1851, p. 21).

[71] I am grateful to Alex Nye for having brought the objection to me.

the law of the land were few and far between because, precisely, sovereign immunity ensured that sovereign debt decisions returned by the stock exchange committee would not be second-guessed by conventional jurisdictions, *since they did not rely on the same enforcement tools*. Because the settlements it brokered were "voluntary" (which does not mean that there was no coercion at work to secure such outcome), they could not be struck down easily, unlike what had happened for instance when Spanish and Portuguese creditors had tried to mobilize the Lord Mayor's foreign attachments. Ironically, because of sovereign immunity, the stock exchange was both a subaltern jurisdiction *and* the highest authority for sovereign debt, which contributed paradoxically to its invisibility.

This was understood by contemporary observers. The media frequently characterized the stock exchange committee as a sovereign debt tribunal. Its verdicts were discussed, favorably or critically but in all cases, it was understood that the stock exchange committee's rulings could project enormous power. For instance, the *Morning Chronicle* complained in 1831 that in striking down a Portuguese debt discharge, the "tribunal of the stock exchange" had exercised "more arbitrary power than would be permitted in the legislative or in any court of England."[72] Yet, standing in the way of a full scholastic understanding of its role, the law of the stock exchange was cultivated within a community of insiders, and its detail rarely reached the non-experts. In fact, preoccupation with public criticism and the risk of regulatory interference by Parliament encouraged the stock exchange's leaders to keep a low profile.[73] Another factor was the legally explosive nature of the material disclosed during committee hearings, which involved para-legal activities as in the case of forward bargains, illegal until 1860. Such proceedings had to be kept secret, meaning that there were no court reporters and reports. To protect itself and its witnesses, the committee resorted to a trick that consisted of treating hearings as private interviews, which placed communications under the mantle of the law of qualified privilege and it protected the identity of witnesses. Finally, while committee "motions" (as committee verdicts were known) were posted inside the exchange and as a result were made public, only insiders with direct knowledge of the proceedings could have knowledge of the complete picture.

Yet eventually, a chairman of the stock exchange committee gave the game away. In 1875, against the backdrop of a resounding sovereign debt crash, an influential parliamentary investigation, the Select Committee on Loan to Foreign States was put together to investigate sovereign debt origination practices.[74] A question that preoccupied the lawmakers was the role the stock exchange committee played in the issue process. MPs were under the impression that the committee played a gatekeeping function (and thus that it bore responsibility for new

[72] *Morning Chronicle*, January 18, 1831. In this context, indeed, the committee had all but decided who was the legitimate ruler of Portugal.
[73] An episode of political intervention by Parliament was the attempted creation of a "rival" stock exchange in 1810 (See Morgan and Thomas 1962). For historical discussions of the interaction between scandal and parliamentary interventions, see Taylor (2013).
[74] See Flandreau and Legentilhomme (2021).

listings). But as Chairman de Zoete explained, they had it wrong. The committee was not a regulatory body. This declaration aroused perplexity and so, the chairman elaborated: Bondholders had the right to ask the committee to prevent the introduction of any new loan if they felt it did violate the laws of the stock exchange. In case of an objection being filed with the Secretary, a hearing would ensue and if the charge had merit, the loan would be struck down. As a result of this litigation function, the chairman explained, the stock exchange committee had come to wield a powerful role. It had evolved from being initially a "tribunal [for the] regulation merely of [the exchange's] internal business [into] *a quasi-judicial position, recognized by courts of law, in many cases in matters connected with foreign* [government] *loans*." "Foreign states" themselves had "admitted the jurisdiction of the stock exchange in these matters."[75] This, and more generally, public revelation that the committee was really legal Plan B, triggered a storm of exclamations among lawmakers believing, as they usually do, that *they* were making the laws. But then adults explained how babies are made and tempers recovered.

PART III. DESCENT OF A SOVEREIGN DEBT TRIBUNAL (1798-1827)

As I have indicated already, the law merchant of sovereign debt as it developed at the London stock exchange in the 19th century can be traced to yet another brand of law merchant dispensed by the same jurisdiction to deal with what was at bottom a similar problem – the problem of stockbroker failures. As stated too, the latter was developed because the main instrument in the market – forward bargains – were illegal and thus not enforceable. Both illegal derivative products and sovereign debts were unenforceable before British courts of justice and both ended up enforceable in an oblique fashion. This part of the article analyzes the birth of this original legal knowledge. It closes with the discovery of the pivotal role played by the ratable interpretation of the equal treatment of creditors, which was assumed under the law of the stock exchange.

a) Illegal Derivatives and Private Bankruptcy in the London Stock Exchange

The Act of Barnard of 1734, confirmed by subsequent statutes and upheld by courts of justice, outlawed derivative trading.[76] As a result, although since 1731 stockbrokers had been placed formally within the remit of the country's bankruptcy statutes adopted under Queen Anne in 1706 and 1707, courts of bankruptcy hardly offered an attractive venue.[77] To be precise, failed

[75] Select Committee, 1875, pp. 23 ff. (my italics).
[76] See Morgan and Thomas (1962, p. 62 ff) for a classic discussion of the point, along with mention of some relevant decisions. See also Cope (1978).
[77] 4&5 Anne c 4 "An Act to prevent frauds frequently committed by bankrupts" and 6 Anne c 22 "An Act to explain and amend an act of the last session of Parliament for preventing frauds frequently committed by bankrupts." On stockbrokers brought under the bankruptcy statute, see Keyser (1850, p. 32).

stockbrokers and their creditors could *technically* place themselves within the authority of British courts of bankruptcy, but they had to be prepared for unpleasant outcomes: The courts would strike down all the derivative contracts in the books of the defaulter since they were illegal and there was a risk for further complications if "relators" (informants) got evidence. The case of the Daniels Fraud in 1806 offers a case in point: To get out of commercial distress Daniels contracted large debts in the stock exchange, then declared bankruptcy and absconded, counting on his commercial creditors to cancel the stock exchange debts in court. In fact, courts of bankruptcy could only help if everyone cooperated to declare illegal debts legal, but such cooperation could not be expected to hold, since the bankruptcy context does create inherent incentives to scramble for a defaulter's assets.[78]

The point therefore is that failure at the stock exchange lacked a dedicated bankruptcy regime. The result was the development in the stock exchange of a self-administered, customary law of bankruptcy. The process left few traces in the record but evidence suggests that it began to coagulate in the summer of 1787 on the heels of a stock market crash that caused upward of forty simultaneous stockbroker failures. A group of sages convened for one week to produce bankruptcy guidelines. The detail is lost but for one subset of rules that was emphasized in the media and provided the foundation for the mechanism that existed afterwards. As per the new guidelines, proper default required full disclosure, in particular the opening of his books by the bankrupt. The penalty for non-cooperation was exposure of the individual's name on a blackboard created for the occasion.[79]

Against this backdrop, the customary bankruptcy process that emerged was as follows. Default typically took place on the periodical settling day, because this was when stockbrokers were asked to perform their forward bargains (though a defaulter could avow himself to his creditors in advance). In case of non-performance the defaulter became dubbed as a "lame duck." He had to walk out of the market (or was escorted out) and he was required not to return until he had made good with creditors thus helping to enforce a de facto stay. Meanwhile, he was placed in a limbo and was expected to negotiate in good faith, making full disclosure. At that point, some defaulters took advantage of the Act of Barnard and were never seen again. But the majority cooperated with creditors. The detail of the bankruptcy was left to the appreciation of parties, with the occasional help of an arbiter drawn from the more senior members of the market. The market also had a police: For instance, trespassers who sought to re-enter the market before they had settled with creditors exposed themselves to being roughly handled. They'd be knocked out of the market, sometimes chased for miles in the streets by a roaring mob of stockbrokers who executed justice themselves or delegated their young clerks as hitmen.[80]

[78] See Flandreau (2019) for an analysis of the Daniels Fraud.
[79] For this and the discussion in this section, see Flandreau (2022).
[80] See Flandreau (2022), for details.

Of course it was in the interest of creditors to make sure that defaulters be placed in a position to pay back their debt, explaining why cooperation was the preferred outcome. Re-admitting defaulters in the market offered significant advantages, including that they'd continue to execute orders and levy commissions under the watchful eye of their creditors. In the ideal outcome, a write-off was granted (it was spoken of as "compromises"). The debt was capitalized and the defaulter allowed back in. From anecdotal evidence it appears that the "haircuts" granted in such discharges could be extensive, if circumstances warranted.[81] There is evidence of situations where creditors would direct additional business to the defaulter since this would benefit them ultimately. The process was ostensibly informal but "formal" legal instruments were mobilized, such as bank accounts in the name of individual creditors playing the role of assignees. Or, deeds of trust were resorted to in order to collect and distribute defaulters' assets.

As a result of the myriad situations thus created and resolved, a bankruptcy knowledge began to accumulate. In the last days of 1798, this provided the backdrop to the creation of a court of bankruptcy, known as the stock exchange committee, described at the time as a "standing committee […] for the express purpose of considering and determining in all cases respecting defaulters."[82] One concern with customary failures had been that, with no legal venue to appeal abuse, settlements brokered in the shadows might be vulnerable to manipulation, connivance and arm-twisting. Large creditors were said to bully defaulters into giving preferential treatment over smaller ones. As shown in Flandreau (2022), the committee remedied this by establishing a number of formal rules, giving itself jurisdiction over stockbroker failures and fleshing out a code of bankruptcy that rested on absolute transparency.[83] The previous template of "bankruptcy by haggling" was put under the central authority of the stock exchange committee, which coordinated the actions of creditors and debtors and provided a venue for anyone to appeal an outcome. This enhanced coordination, because uncooperative individuals (whether debtors or creditors) could be sanctioned through exclusion from the community.[84]

The first stock exchange committee comprised senior market operators, typically market makers, individuals of great prestige and whose names feature in fact in earlier informal arbitration decisions. Its first chair was John Battye, a key individual in the process whereby the embryonic law of default was turned into a jurisprudence. He would occupy the position until he resigned in 1801 and contributed heavily to the first decisions. For that reason, sources describe him as the "father of the stock exchange." The first committee had been self-appointed, then shortly after proclaimed in the House. Later, with the incorporation of the stock exchange as a voluntary

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[81] Mortimer (1795), an outspoken critic of the stock exchange, complained of discharges being "paltry compositions."

[82] MSS 14600/1, p. 5.

[83] The committee was known colloquially as the stock exchange committee, though its formal name was actually the "committee of the stock exchange, appointed for general purposes."

[84] See Morgan and Thomas (1962); Michie (2001); Weidenmaier (2019), drawing on these sources, offers an illustration of lingering confusions about the primary role of the London stock exchange committee.

association in 1801, it was decided that a formal appointment process of the committee, by now the executive organ of the association, was legally preferable. Afterwards, the thirty sages forming the committee would be balloted annually by the gentlemen members of the stock exchange.[85]

b) The Mother of all *Pari Passu*

The bankruptcy law of the stock exchange committee as it coagulated in December 1798 comprised two parts. On the one hand, there was a bankruptcy statute. All failures had now to be reported to the committee and placed under its tutelage. The books of the defaulter were thrown open, debts inventoried and creditors asked to come forward. They appointed a "managing creditor," acting as assignee and serving as liaison with the stock exchange committee. Attempts at concealing evidence (for instance, refusing to surrender the books) would lead the perpetrator to be reported by his creditors. If he persisted, the committee would expose his name on the blackboard. The stock exchange also formalized a concept of honest failure. If an individual defaulter was found upon investigation to have honesty and if he cooperated in good faith, he would be swiftly re-admitted in the market and benefitted a generous discharge. Once readmitted the discharge would protect him against any pending claims, for instance from late-coming creditors, and he could appeal to the committee if he faced bullying by individual creditors.[86]

The second building block of the institutional innovation of 1798 concerned the management of creditor priorities. Under the law of the stock exchange, all debts ranked equally and, what is more, shares in stock exchange recapitalizations would be *proportional* to debts. Following the same logic, payments out of the restructured debt would be computed on the basis of the proportional share of each creditor's claim (the archival record speaks of "ratable" payments). The jurisprudence of the exchange introduced in fact what amounted to a claw back provision. In particular, "stoppages" whereby a creditor intercepting more than his ratable share was strictly prohibited. If detected and reported, the surplus would have to be returned to the creditor pool.[87]

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[85] See Neal (2006) for a discussion of the design or "micro-structures" of the London stock exchange. Neal does not engage with the reasons for creating the stock exchange committee, though the evidence here is consistent with the account he gives.

[86] See Flandreau (2022) for a discussion of this point and examples.

[87] As would be established subsequently, no priority or collateral security would be tolerated, for it was perceived to provide a surreptitious mean to secure a non-transparent advantage. Another reason may have been that courts of justice deemed the collateralization of illegal bargains void since they afforded a way around Barnard. In *Faikney* for instance, Judge Cox spoke of posting collateral against illegal bargains as being an "evasion of the Act" that would render it "quite nugatory." "The money would," he added, "always be paid in this Method, if this Method should now be allowed." (Faikney v Reynous, 3 T.R. 418, p. 2071). If stockbrokers were using collateral, they created a hazard in the shape of possible litigation in courts. In keeping with the effort to uphold the insularity of the law of the stock exchange it was better to render collateralization illegal.

This latter principle resulted from what was in fact the first verdict ever returned by the stock exchange committee, *Nisbett v. Levien*.[88] Nisbett was a market maker (jobber), the creditor of Levien, a significant stockbroker who had failed in 1796. Along with the other creditors, Nisbett had then consented to discharge Levien through custom. The agreement between the gentlemen provided that the debts be repaid through annual installments and the defaulter would be allowed to return to the market. The dispute arose because in December 1798, Levien recorded a significant trading gain against Nisbett, leading the latter to announce that he would charge that gain against the debt owed him. In the language of the time, Nisbett attempted a "stop." The move prompted a "violent opposition" from one of the other creditors of Levien who objected to the preferential distribution. As a result, Levien and Nisbett went to the newly formed court of justice asking for guidance.[89]

The ruling, delivered almost instantly, supported the ratable interpretation of the equal treatment of creditors: It instructed Nisbett to pay over his full loss to Levien, and retain nothing for himself. Levien was expected to continue to pay his creditors according to the original plan, and in particular, proportionately to the debts without any accelerated payment in favor of such or such. The interdict on stoppages and the associated claw-back provision were upheld in subsequent decisions, in fact it was eventually written into the official *Rules and Regulations* in 1812, which provided that no creditor could ever retain a "*larger proportion*" than the whole body of the creditors and that in case he had nonetheless, then he would be expected to refund "*such a portion of it, as shall reduce his dividend to an equality with others*."[90] It is hard to think of a clearer statement of the ratable logic.

In fact, this ratable logic interpretation of the equal ranking of stock exchange debts was the cornerstone of the whole jurisdiction. First, mention of a "violent opposition" of one of Levien's creditors to Nisbett's attempted stop proves that Nisbett was transgressing a natural understanding. More importantly, the evidence also shows that the market aspired to the verdict. Indeed, the transcription of Nisbett's deposition speaks of individuals identified as "very respectable gentlemen" urging the disputants to direct their quarrel to the new committee, because "this question is of such importance that it should come before a committee of the whole House."[91] As this was the first verdict ever delivered, it is hard to avoid the conclusion that the choice of this particular dispute was not random: Because it was a new creature, the committee

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[88] For simplicity, I record cases in the format X v. Y though initially, this was not how disputes were recorded.
[89] MS14600/1, p. 5 ff.
[90] See Stock Exchange Committee (1812, p. 35, rule 5 under "Failures." Emphasis Added): "No creditor of a defaulter shall pay himself or any other creditor, *in a larger proportion* than to which the whole body of the creditors are entitled. And if a creditor shall, by any means, have received a larger proportion than that to which the whole body of the creditors are entitled, he shall refund such a portion of it, as shall reduce his dividend to an equality with others."
[91] MS14600/1, p. 5 As a result, the same gentlemen argued, "they [the committee] may thereby have an opportunity not only of deciding the question, but of making such regulations as the nature of this and some other cases which have been mentioned to you must necessarily be the result."

was anxious to draw support and for that reason, a no-brainer verdict was picked first, explaining why sympathetic gentlemen hustled the dispute there. It is of course of no small import that the law of the stock exchange was to develop immediately after on the soil of this early *pari passu* ruling: This establishes the foundational character of ratable distributions under the law of the stock exchange: In bankruptcy, a *raison d'être*.

It would be fascinating, but beyond the remit of this paper, to retrace the detail of the process whereby the committee subsequently acquired sway over the life of the stock exchange. Suffice it to say, that by the mere fact that it was a court of bankruptcy – and thus controlled financial death and resurrection at the stock exchange – the committee could wield significant power. For instance, because it had the authority to investigate the books and accounts of defaulters and determine whether they had been honest, it found itself in the business of determining which instruments and modes of trading befitted the honest man in the first place. This led the committee to make regulations, encouraging certain techniques, attitudes or instruments and discouraging others. An illustration is the trading of options. Initially the committee had set its head against them. Of course traders could and did violate the rule but then the committee had an instrument to penalize them if it caught them red handed: On the back of a failure, options found in the books were wiped out from the balance sheet. What is more, by standing in defiance of the law of the stock exchange, transgressors may have forfeited the opportunity of a more lenient discharge.[92]

c) Enter Sovereign Debt

The next crucial development was that this function of the stock exchange committee as tribunal for stockbroker failures provided the foundation upon which its function as sovereign debt tribunal was built. The evolution took place in late February 1827 when a new statute was introduced, laying the ground for a sovereign discharge process. The immediate cause was the boom and bust of the first extensive sovereign debt market in the London stock exchange, hit with full force by the monetary crisis of 1825-1826.[93] Of the 24 individual foreign government loans issued in the London stock exchange since the early 1820s, eight had fallen into arrears at that point.[94] As investors knew, too, no government support would be forthcoming: In 1824, the strong man in the Cabinet, then Secretary of State for Foreign Affairs George Canning, had fleshed out in Parliament the no-bailout policy that the British government would follow in practice until the Palmerston Circular rendered it fully official.

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[92] *Rules and Regulations*, 1812. See Neal (2006) for a discussion of the question of options at a later date and the fierce disputes it triggered.

[93] On this "first debt crisis" see Dawson (1990); On the making of the statute of 1827, see Flandreau (2013).

[94] Author's computations. Numbers adjusted by the infamous Poyais loan, which also went bust. The tally did continue to rise after February 1827.

The debacle of 1825-1826, which snowballed to contractors and caused a sovereign debt run, raised questions for the continued operation of the sovereign debt market. Prominent stockbrokers, large investors for their own account or for that of their friends, faced an outcry against the "financial hell" of the stock exchange. They were wary of reputational damage and of a regulatory intervention. As a result, a number of leading market operators decided to take the matter into their own hands. An opportunity was provided in January 1827 by an attempt to peddle in the London stock exchange certificates of debt, which British claimants had received from Spain as indemnity for seizures of ships. This was read as a surreptitious loan, leading a group of prominent stock exchange members, self-styled "holders of the bonds of the Spanish government," to petition the committee of the stock exchange so they should strike down the certificates. What is more, stating that they had a larger aim in sight, they asked not for a ruling but for a statute: The exclusion of the Spanish certificates was to be elevated to the standing of a formal rule, preventing defaulters in general – not just Spain – from borrowing in the market. As said, the petitioners belonged to the elite of the market, who also manned the committee by rotation and as a result, they had no difficulty securing their prize.[95]

This is how the famous statute of 1827 was born, framed and voted upon on February 28, then confirmed by a second vote on March 2, scribbled at the bottom of a page 406 in the minutes of the foreign stock exchange committee (a sub-committee of the general committee of the stock exchange). The ten lines were to revolutionize the sovereign debt scene: The jurisprudence of stockbroker defaults was transplanted to the realm of sovereign debt. Building their case for a new statute, the petitioners indeed outlined the continuity: They spoke of the historical commitment of the committee to "inviolability of commercial faith." It was to this principle which they now appealed, sure as they were that their proposal was bound to speak to "every member of the stock exchange."[96] In fact, the figurehead of the petition was a stock exchange member named George Battye, the son of the now deceased John Battye, the "father of the stock exchange." Why pick this precise individual if not as a manner of saying that the extension of the committee's authority to the domain of sovereign default was natural?

PART IV. SOVEREIGN BANKRUPTCY AND THE STOCK ECHANGE COMMITTEE

Bankruptcy law is about cooperation – not only cooperation between creditors and debtors but equally important if not more, cooperation *amongst* creditors. Crucially, the discharge statute of 1827 provided for this by giving prior creditors rights over debt write-offs. Debt reductions were

[95] For instance, the current chairman of the stock exchange committee was among the petitioners. On this and surrounding material, see Flandreau (2013).
[96] See MS 14617, 1, p. 402.

possible but they had to be assented to by previous lenders. This invited the development of a law of bankruptcy to resolve differences in the adjudication of such rights as they surfaced. Of course, given that the sovereign debt law of the stock exchange was a spinoff of the stock exchange's Lex Mercatoria a basic tenet of the emerging law of sovereign failure was that distributions ought to be proportional to rights. Just as had been the case for stockbroker bankruptcies, the ratable interpretation of creditor rights is what put the law in motion, and what is more, it was the instrument whereby the London stock exchange upheld creditor cooperation.

a) Sovereign Bankruptcy in a Nutshell

Ostensibly, the statute of 1827 had been about *debtor* atonement. This was how it was sold at the time to the British public. As the *Times* explained, the new statute enabled them to chastise sovereign defaulters: Credit embargoes resulting from application of the statute were there to teach delinquent states a lesson. They would be "committed," as the journal put it to "patience and long suffering."[97] It is also how it has been understood afterwards. In the game theory informed modern literature, the statute is conventionally described as an instrument providing creditor leverage through the "penalty" of market exclusion. From Charles Lipson for instance, "the most powerful weapon [in the hands of creditors] was the denial of further credit."[98] In no account extant (apart from Flandreau 2013), does one find any suggestion that the statute of 1827 was primarily geared towards coordinating *creditors*. To put it in another way, I argue, unlike others, that the stock exchange was not a regulatory agency in charge of administering a penalty system, but a court of justice. Its ultimate function was to be a *default governance* apparatus, and for that reason, it assisted the formation and maintenance of debt restructuring clubs. Indeed, in order to avail themselves of the power of the veto, bondholders had to get organized. To that end, they used fairness rules, which litigation before the stock exchange tribunal served to entrench.

To see this, the best way is to begin with a careful reading of the statute of 1827, which has not been provided thus far. It reads as follows: "The committee will not sanction or take cognizance whatever of bargains that may be made in New Bonds or Stocks or any other Securities issued by any foreign Government that has not duly paid the dividends on former loans raised in this country, *unless that Government shall have effected some satisfactory arrangement with the holders of the Stocks or bonds or other securities on which the dividends have been left in*

[97] *Times* March 1, 1827. The article emphasized a powerful "public interest" at play in the proceedings of the committee. The new statute, it concluded, had "given very general satisfaction on Change. It is high time that all foreign governments should be informed that they are not permitted to commit wholesale plunder in this country without the recoil of injurious consequences upon themselves – a conclusion to which, from the patience and long suffering that has been evinced, some of them have probably come."

[98] Lipson (1985, p. 46); This presentation goes back to the classic works of Leland B. Jenks and Herbert Feis (See Jenks 1927, pp. p. 284; Feis 1930, 114-5). For a discussion of inaccuracies in these accounts, Flandreau (2013). Eichengreen and Portes (1989a, p. 15) also describe the stock exchange committee as an agency controlled by "the bondholders" adding that the veto drew its strength from the "close working relations" that would have existed between bondholder organizations and London Stock; See also Eichengreen (1991, pp. 162–3).

arrears."[99] As can be seen, rather than putting in place a penalty system to hit defaulters, this language sets the terms and conditions of a sovereign debt discharge. A discharge won't be granted, it says, unless the sovereign defaulter manages to "satisfy" creditors. But this calls into being a technology to ventriloquize creditors so that the committee, when adjudicating a dispute, is equipped with evidence to determine whether or not creditors are "satisfied."

The result was the empowerment of bondholder parliaments, an essential cog of the discharge machinery. In the first debt restructurings that took place under the jurisdiction of the stock exchange committee, individuals had showed up introducing themselves as representatives of bondholder committees and since they were known activists, the bona fide of their claims was generally admitted without further ado. In 1834 however, the stock exchange committee was caught in a crossfire between two rival factions of creditors in the context of a Spanish discharge. The response was inspired by the procedure at work in stockbroker failures. The committee stayed the proceedings, encouraging the two factions to hold a general conference, take divisions, and come back with the result of their vote. Two successive bondholder assemblies proved necessary to resolve the dispute, but after the (favorable) vote took place the matter circled back to the committee, which ratified the discharge.[100] This decision, by giving agency to bondholder parliaments, breathed life into the institution.[101]

In essence, failed governments were the new "lame ducks." Like failed stockbrokers, they were excluded from the market, remained in a limbo as they negotiated and emerged from it if, and only if they had made good with creditors. As occurred for failed stockbrokers, compromises that arose out of such negotiation were submitted to creditor assemblies. If a discharge rallied a majority, former defaulters would be returned to the market, under the sanction of the stock exchange. This would protect them against former claims just as it did for the stockbrokers. Discharges extended to sovereign bankrupts could be generous. The debt reductions that resulted could be as high as upward of 50% of the outstanding capital. A full 150 years before Sachs advocated LDC debt forgiveness, the committee of the London stock exchange routinely sanctioned large sovereign debt write-offs.[102]

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[99] MS 14617, 1, p. 406-7. See Flandreau (2013).
[100] The motion read: "The government of Spain having come to a satisfactory arrangement with the Cortes bondholders, the grounds for excluding other Spanish securities from the stock exchange market is thereby removed." MS 14600/14, November 15, 1834, p. 184-5, MS 14600/14, Dec. 1, 1834, pp. 189-90. MS 14600/14, Dec. 24, 1834, pp. 202-3; *Morning Post*, "Spanish Loans," December 16, 1834; *Morning Post*, "The Spanish Loans," December 23, 1834.
[101] Close to 250 sovereign bondholder assemblies would be held between 1827 and 1873 for about 60 discharge votes (Figures drawn from ongoing research).
[102] Sachs (1987). See Flandreau (2013). Author's estimates from current research. See Meyer et al. (2019) for contemporary "haircut" figures consistent with this.

b) Sovereign Bankruptcy and the Ratable Logic

A consequence of the system just described – one whose importance has been so far missed – is that the stock exchange committee was not concerned with the status of loans and readjustment negotiations themselves, only with determining whether creditors felt that the country had settled satisfactorily. As it was put at the time, the committee busied itself with "ascertain[ing] the real feeling of the bondholders generally."[103] If bondholders were satisfied then the stock exchange committee, constituted as a bankruptcy court, would likely rule in favor of the discharge. Because of this function, the committee was concerned with formalities: The integrity of the method whereby the position of the bondholders was identified had to be protected through careful adherence to due process. For instance, the committee would busy itself with ascertaining whether adequate publicity for bondholder assemblies had been provided, whether a full and thorough debate had been allowed during the assembly, and of course what were the divisions – beyond mere evidence of a majority. In sum, the committee saw itself as a bankruptcy court, tasked with upholding the integrity of discharges, since its own reputation as arbiter was at stake.

In fact, the committee's ratable interpretation of creditor priorities was tied to this focus. The heterogeneity of debt titles created scope for manipulation of bondholder assemblies. Manipulation could crop up when different debt titles existed, enabling debtors to discriminate among creditor groups. They could take advantage of the majority rules to exploit the system. Against this backdrop, it was essential to ensure that no legitimate claim would be stifled: It was one thing for the stock exchange to let a majority decide what identical treatment all bondholders would receive, it was another to let a coalition between the defaulter and the majority tyrannize the minority. Of course, the committee had the tools to deflect such risks: The attempt would violate the jurisprudence of the stock exchange which, as seen in the case of stockbroker failures had provided that "no creditor of a defaulter shall pay himself, or any other creditor, in a larger proportion than that to which the whole body of creditors are entitled."[104] Equitable distributions were the touchstone of successful (i.e. litigation-proof) sovereign debt discharges, while litigation was the manner in which the judges in the stock exchange were made aware that there was a problem.

An instance of that kind occurred during the negotiation of a Spanish discharge in the Summer and Fall of 1851. Spain had been in default since the 1840s and some bondholders had sold their unpaid coupons to distress investors. As a result, there were two types of creditors, the bondholders and the coupon holders. Moreover, the coupon holders were fewer in number and capital than the bondholders. Against this backdrop, Spain had an incentive to offer a more favorable debt arrangement to bondholders compared to coupon holders. This is what it did in 1851, with a decree that offered one conversion rate for ordinary bondholders and another, lower

[103] MS 14600/17, pp. 187 ff.
[104] Committee for General Purposes (1812, p. 35).

rate for coupon holders, penalized by an extra 50% write-off. As managers of the bondholder conference gathered to vote on the discharge argued, it looked like Spain was trying to engineer what they described as a "clashing of interest" among creditor groups.[105]

However, the law of the stock exchange ensured that the attempt petered out. As one of the leaders of the coupon holders put the matter during the assembly: "If Spain said to her creditors – 'Gentlemen, have pity on me, because I am poor and in misery, and cannot pay more than this small sum!' I, as a creditor would reply, 'If that be your position, I will not be hard upon you – I will take your money – I WILL TAKE YOUR MISERABLE STIPEND.' But then, if your creditors are to receive that money, let it be fairly divided amongst them, AND NOT SO AS TO AGGRANDIZE ONE SECTION AT THE EXPENSE OF ANOTHER."[106] In the end, what happened was that the motion voted by the assembly was framed so as to *reserve the rights of the minority*. The point is, had coupon holders been sidelined, they would have been enabled to litigate the discharge, and this nipped in the bud exploitation. In the final outcome, which emerged in the next few months, the coupon holders received the exclusive right to lift the embargo. This committed Spain to compensate them if it wanted to restore market access, which eventually occurred in 1867.

As one contemporary bondholder summarized the situation, in sovereign bankruptcies all creditors expected to be "placed on the same footing," giving them the right to litigate payments violating equitable treatment.[107] Thus, sovereign creditors expected distributions of new rights, cash payments, and other indemnities to be proportional to the relative positions of the old rights. The exact proportionality was to be assessed by the parties, but ultimately, they could be arbitrated by the stock exchange committee. Not only did threat of litigation render manipulation futile, in fact, it secured creditor cooperation. To repeat, obstruction before the stock exchange committee (or threat thereof) was the corrective mechanism that kept creditor rights on an even keel. Ratable distributions as an expression of creditor equal treatment were not the weird fancy pictured by the contract originalists. With good reasons, they captured the essence of the sovereign bankruptcy template, which the London stock exchange committee, building on its law of stockbroker failure, had put together.

Not a small consequence was the ubiquitous presence in sovereign debt negotiations of solemn calls for, and pledges of, "equal justice" towards alternative classes of creditors. They were to be placed on the "same footing," dealt with "without preference," etc. Defaulters understood that departure from stock exchange enforced norms would cause coveted discharges to elude them. They would be anxious to signal their commitment to fairness as a precondition to the opening of negotiations, lest they face the opprobrium, which Spain's attempted spoliation in 1851 earned

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[105] See Anonymous (1851).
[106] Anonymous (1851, p. 10, 13).
[107] *Morning Chronicle*, May 18 1846, "The Mexican Loans."

this country. Examples are legion and their systematic collection could rapidly fill up the shelves of the legal archaeologist.

One instance is provided by the already discussed Spanish discharge of 1834, which involved different groups of claimants. As a preamble to the opening of negotiations, the Spanish Minister of Finance did make a solemn declaration stipulating that in any case, all debts would "be *equally* treated and *without preferences*" thus sending a strong signal that he understood how the law of the stock exchange operated.[108] Another episode occurred in February 1843 as a Portuguese discharge was being negotiated. Negotiations involved two constituencies owning different rights. A heated exchange erupted when one bondholder group accused the other group of trying to secure better terms for themselves. The Portuguese minister Baron do Tojal stepped in with an open letter published in the London press, pledging his country's commitment to "impartiality and justice" towards both groups. The intervention and commitment to keep both interests on an even keel made sense because each group was led by a redoubtable stock exchange litigator who had ambushed previous discharges and could thus derail the whole process.[109]

These episodes take us to the Santa Anna decree pledging equal treatment of the creditors of Mexico in 1843, only a few months after the Portuguese episode. It has been branded a unique find by Chabot and Gulati and they have also suggested that equal treatment did not mean ratable payments but fear of the gunboat. Yet a more compelling explanation is that it was the fear of litigation at the stock exchange that prompted the pledge. Just like the Spanish and Portuguese cases, the decree occurred against the backdrop of suspicions of creditor discrimination. As Chabot and Gulati in fact describe, a situation developed following the debt settlement in 1837, whose finalization was suspended by French military intervention in Mexico.[110] Different debts were serviced differently. This triggered complaints by creditors, reflected in attacks in articles in the British press, emphasizing the need for "equitable provisions." While the *Morning Herald* emphasized that all creditors should be placed "on an equal footing,"[111] the *Times* objected to an attitude "giving an undue preference to one description of creditor." Its position was that Mexico's "credit can never arrive at a *satisfactory* state in Europe until they have contrived some means of placing all their creditors upon a *perfectly equal footing*."[112]

Given that the *Times* was a well-informed journal, in fact the mouthpiece of the stock exchange, reference to the need to create the condition for a "satisfactory" situation resonates distinctly as a

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[108] Pebrer (1834, p. XIV). Emphasis in original.
[109] For the letter by João Gualberto de Oliveira, Baron do Tojal see the *Morning Post*, 10 February 1843. The first group led by veteran activist Richard Thornton comprised the general debt of Portugal. The other group, led by I. L. Goldsmid, another veteran activist, consisted in holders of the so-called "Portuguese Five Percent 1836" which enjoyed a special guarantee from Brazil.
[110] Wyllie (1840).
[111] *Morning Herald*, 14 May 1840.
[112] *Times*, 11 June 1840.

nod towards the stock exchange statute of 1827. Against this backdrop, it is not surprising that General Santa Anna's decree did promise equality, because under the discharge statute of the stock exchange, failure to treat creditors equitably amounted to the continuation of default. Unless one accepts a bizarre theory suggesting that the Navy would have cumulated the role of being a collection agency for bondholders, which I argued it never had, with an even stranger function consisting of adjusting bondholder priorities as Chabot and Gulati have done, we are left with a more natural alternative: That the Santa Anna decree demonstrates the Mexican executive's understanding of the law of the London stock exchange, an understanding it shared with leaders of other defaulting countries such as Spain and Portugal. For all these policy makers, *pari passu* provisions were granted in order to secure a formal discharge and they meant ratable payments. The final act was the reproduction of the decree into the general bond, a standard procedure at the time because the stock exchange insisted on securing evidence of the powers under which any new loan was issued: In this manner, the *pari passu* language made its way into the bond. [113]

c) Bankruptcy Avant-Garde

In conventional genealogies in general and in the contract originalism literature in particular, sovereign bankruptcy is a spin-off of other legal doctrines that govern distress, typically corporate bankruptcy statutes such as Chapter 11. In a similar fashion, previous scholars have turned to classic English corporate law textbooks from the late 19th century, believing this was where one ought to start. To wit, Buchheit and Pam conclude their historical survey saying that the "*pari passu* clause has migrated from its *original home* in nineteenth century secured domestic debt instruments into the unsecured cross-border debt instruments of the last thirty years."[114] But the original home of *pari passu* provisions was never secured domestic debt instruments. It was *unsecured stockbroker debts*. In fact, as I now show, this genealogic modification has far reaching consequences for our understanding of the origins of sovereign debt. Not only does my alternative archaeology points to a different point of origin for *pari passu* clauses but it also suggests a reversal of causal direction between corporate and sovereign debt bankruptcy, the later in fact an avant-garde.

The reason for the avant-garde character of the sovereign debt law developed by the stock exchange was its pragmatism. As a result of its inability to seize the assets of defaulters (be they

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[113] For evidence that *not* including the text of the decree see Minutes of the Committee of General Purposes (14600/22, p. 50). In March 1852, a question was raised by the incomplete inclusion of the text of a Mexican degree in the general bond. This was considered sufficiently serious to motivate a suspension of the listing procedure until the matter was cleared. "As it was intimated that some portion of the decree under which [the bonds] were issued was not inserted in the Bond [meaning the General Bond], Mr. Capel [Chairman of the bondholder committee] was sent for and having explained satisfactorily, they were ordered to be marked." Accordingly, the bonds appeared in the official list a few days later. More generally, on evidence of formal powers of issue as listing requirement, see Select Committee (1875), interview of Herman de Zoete.

[114] Buchheit and Pam (2003, 35). My italics.

stockbrokers or sovereigns) the law of the stock exchange focused on what it could lay its hands on – the end game, the discharge – because this was when defaulters could be ambushed and brought in line. This fundamental fact of life elevated creditor cooperation, the cornerstone of the whole process, to a position that was unparalleled in contemporary British bankruptcy. British corporate bankruptcy statutes were an intimidating institution designed to control defaulters. It built on an arsenal of punitive instruments, including the possibility of committing defaulters to a debtor's prison, the right to search their vacated house or to attach their bank assets. The discharge emerged as an afterthought, an attempt at complementing the stick with a carrot. At the dawn of the 18th century, the statutes of Anne laying out the foundations of modern British bankruptcy law conceded write-offs to cooperative bankrupts, but only if they secured the support of a qualified majority of creditors, initially four-fifths of creditors by number and value. Upon recommendation by creditors, the Bankruptcy Commissioners would issue a certificate of conformity which, if ratified by the Lord Chancellor, would give a clean slate to the former defaulter.[115] Against this backdrop, the self-governing tribunal of the London stock exchange emerged as a field of experimentation, enabling the accumulation of bankruptcy knowledge and eventually inspiring reform in corporate bankruptcy.

In fact, by the end of the 18th century, the repressive character of the bankruptcy statute was deplored by the more advanced segment of the economy. For that reason, too, an alternative template, contractual in nature, was being slowly developed. Familiarly known as "private bankruptcy," it eschewed the Statutes of Anne and sought to inject flexibility by enabling parties to discharge via contract. Courts of justice admitted the common law logic and by the beginning of the 19th century, a coherent corpus of decisions was emerging, known as the "law of composition with creditors."[116] Debt write-offs became part of a compact known as Letter of License, binding debtors and creditors to undertake certain actions. A Deed of Trust was established to hold the defaulter's estate. Such arrangements were capacious: If circumstances warranted, defaulters could even remain in charge of the business as managers and would recover their former position once debts were cleared. The limit was that the condition for the contractual approach was *unanimity* of the parties. Individual creditors retained the power to opt out and request the intervention of the court of bankruptcy should they so wish, in effect derailing the attempt.[117]

Despite this, private bankruptcies gained ground, becoming the preferred choice of banking, finance and modern mercantile establishments. For instance, an often-quoted report of the Law Society of the United Kingdom from the mid-19th century found that, of the 120 houses that had failed in the crisis of 1847, only nine had opted for the statutory route, the rest – an immense majority – preferring the contractual one.[118] This preference was understandable. Courts of

[115] Hoppit (1987); Carlos et al. (2019).
[116] Montagu (1823) was apparently the first one; See Hoppit (1987) for a discussion.
[117] Hoppit (1987: 41).
[118] PP no. 1770. (p. 86).

bankruptcy charged non-trivial legal fees, nibbling away the defaulter's estate. Other things being equal creditors were better off under the private approach, especially since availability of the nuclear option (putting the matter in the hands of the court of bankruptcy) disciplined initial bargaining. But as said, unanimity was required, empowering arch or vindictive creditors. Another challenge was, if things got out of hand afterwards, recourse to courts would be necessary, and verdicts might be unpredictable and slow. These difficulties led to repeated calls for mollifying unanimity rules and for placing privately contracted discharge agreements under the authority of courts of bankruptcy, which would ratify the agreements, giving them greater legal force.

Against this backdrop, the bankruptcy law developed by the London stock exchange was a natural source of inspiration. It had in fact the highest degree of flexibility extant at the time: The mechanism it upheld entrusted parties with complete authority while providing a tribunal to sanction the outcome and if need be, adjust differences. Because the stock exchange stood guard as ultimate gatekeeper of the quality of discharges, significant flexibility was conferred to the overall process. The condition generally admitted by the stock exchange – support of the majority of creditors – was significantly lower than in the corporate context.[119] In sum when British bankruptcy statutes reduced information asymmetries through severe penalties and tolerated cooperation as a carve-out on an otherwise repressive statute, the stock exchange had designed a uniquely flexible solution, which guided the parties while rewarding their ability to agree.

Of course, this flexibility had grown out of pragmatism – because it was the stock exchange's way or the highway. But the end result was the creation of a field of experimentation, where ideas harbored by corporate bankruptcy reformers championing a greater reliance on creditor cooperation could be tested and refined. This approach ended up forging a way forward, in fact anticipating on future developments in the "official" system. As previous scholars have noted, flexibility was indeed the horizon towards which the British private bankruptcy system was inching. After long debates, setbacks and turnarounds, a landmark was the Bankrupt Law Consolidation Act of 1849. The Act was a turning point in that it began to integrate the two bankruptcy systems (the official and the private contractual) lowering the threshold for a discharge in official bankruptcies while diluting the power of hold-outs in private compromises, which were sanctioned by courts of bankruptcy. This was substantially what the stock exchange had been doing for quite some time.[120]

In other words, the stock exchange offered a template and model for bankruptcy reform. Knowledge spillovers were inevitable in the City because if individual bodies of law were

[119] For evidence on majority rules (by amount and number) as the relevant criterion for sovereign debt discharges, see MS 14600/17, May 3, 1841, p. 206. The "laws of the stock exchange" would bind the committee to the position of the holders of half of the bonds.
[120] On bankruptcy law and bankruptcy reform in Britain in the 19th century see Lobban (2010, 2015).

independent from one another, financial portfolios were not: Alternative legal venues and alternative legal regimes were brought into natural comparison by the fungibility of money. Human carriers supported the transplant: In particular, prominent stock exchange lawyers – stockbrokers who had developed a specialty in stock exchange litigation – made their way into corporate law. An example is provided by David Salomons (1797—1873), member of the Anglo-Jewish financial elite who was related to the Rothschilds. Salomons began his career as an operator in the foreign stock market, a dealer (or "jobber") in Brazilian bonds. This position led him to become involved as counsel for bondholder protective organizations in several prominent episodes of debt discharge litigation, in particular the Portuguese debt restructuring of 1831, which involved delicate questions of sovereignty. Salomons took care of litigating against a rival loan, which bondholders wanted struck down, and later in favor of an alternative debt restructuring, which bondholders supported.[121] He was successful in both cases. After becoming the Alderman then the Mayor of London, Salomons joined the bar in 1849, practicing corporate law before he became the first Jewish magistrate in England. The point is that Salomons' practice was informed by his prior experience in the stock exchange as counsel in sovereign debt restructurings.

In fact, delving through the list of bankruptcy reformers who lobbied Parliament during the 1830s and 1840s in order to press bankruptcy reform, we find many friends and allies of the stock exchange, especially those involved in sovereign debt, including distressed debt operators and activists. For instance, an influential petition brought out in 1848 by a group of self-described "merchants," calling for the injection of greater flexibility in bankruptcy and directly paving the way for the Act of 1849, is signed by what turns out to be a collection of prominent sovereign debt contractors.[122] Among them we find Richard Thornton, of Thornton and West, who chaired multiple foreign bondholder committees and was one of the most prominent distressed debt investors of the time. In fact, Thornton's bondholder group was the plaintiff in the aborted Portuguese discharge in 1831 and the defendant in the successful discharge secured in 1831-33, for which Salomons had acted as counsel.[123]

The matter could detain us much longer. The short description is that, in a more balanced history of sovereign bankruptcy, the law of the stock exchange should to be understood as a site of primitive accumulation of legal knowledge, subsequently irrigating other bodies of law. The evidence we have certainly casts doubt on conventional suggestions that sovereign bankruptcy is a knowledge without a history, to be conceived synthetically from universal ideas pertaining to private bankruptcy. In fact, both sovereign and private forms of bankruptcy are part of a history of cross-pollination. What is more, in the first half of the 19th century, the cooperation-based hyper-flexible approach to discharge, closely tutored by a court of justice, as captured by the

[121] Flandreau (2021).
[122] *Report of Her Majesty's Commissioners Appointed to Inquire Into the Fees*…, p. 91. On bankruptcy reform and lobbyists with stock exchange connections, see also Lobban (2000).
[123] Flandreau (2021).

brand of sovereign bankruptcy law which the stock exchange committee upheld, represented a kind of destiny. The court and the flexibility it promoted were in the driver's seat, while the more rigid attitudes still prevailing in official courts of bankruptcy dealing with private failure were in tow. And as said, it was ironically limitations imposed by the sovereign immunity doctrine, then at its zenith, that had precipitated sovereign bankruptcy at this legal *avant-garde*.

PART V. *PARI PASSU* REGAINED

I now harness the insights from the previous sections in order to make sense of the descent of actual *pari passu* provisions in sovereign debt covenants. To that end, it is best to start once again with the "dead ends" which the previous literature has encountered and show that there is a way out. As a result, my focus from now on is on making sense of the debt contract concocted for Bolivia in 1872. At one point in their investigations, contract originalists have argued this "Church Contract" provided the first instance of a *pari passu* clause before changing tack and focusing on the Santa Anna decree instead.[124] Gulati and Scott report being unable to explain the object of the clause in the Church Contract, in their own terms to unlock the "meaning the parties attached to the first formulation of *pari passu*."[125] That the first mutation is inexplicable (and thus, random?) plays a central role in their reading of *pari passu* clauses as an epidemic propagated through the infernal logic of boilerplate contracts.

However, I show in this section that it is possible to turn the tables: The *pari passu* clause in the Church Contract presents us, not with an unsurmountable challenge, but with a unique opportunity to understand the meaning of *pari passu* clauses. As I will show, they were in fact the product of deft financial engineering by individuals who were privy to the bankruptcy law of the London stock exchange. In fact, unpacking the Church Contract does permit the unpacking of how the sovereign debt law of the stock exchange really worked. As we shall see, *pari passu* clauses were not introduced randomly but with clear intent, by sophisticated drafters (lawyers and stockbrokers) with an experience of stock exchange litigation. These drafters were aware of the legal mechanics of the stock exchange sovereign debt tribunal and crafted the clauses strategically. We are very far from the originalist's tale of random boilerplates.

a) Contract Linguistics

To begin, a remark: Sovereign debt contracts under the law of the London stock exchange needed not specify equitable treatment per se, because equitable treatment was assumed under

[124] Gulati and Scott uncovered this contract in the collection of foreign debt documentation they put together with Weidemaier and their students and they discuss it in Gulati and Scott (2013).
[125] Gulati and Scott (2013, p. 135-6): "Ultimately, despite the fascinating story of Colonel Church and his Bolivian Bond, we were unable to find any clues either in the litigation reports or the bond itself that unlocked the meaning the parties attached to the first formulation of *pari passu*."

the law and jurisprudence of the stock exchange. Seized by the aggrieved party, the court would see to it that unadjusted claims be compensated and for this, all that was needed were carefully written descriptions of the financial characteristics of the securities (coupons, maturities, amortization scheme, and so on). In other words, rankings were *implied* by language in covenants. So for instance, in the event of a discharge, two perpetual bonds of a nominal value of 100 with coupons of 5% and 6% respectively would be converted at proportional rates so as to uphold equitability. This did not raise particular problem: The world we are dealing with was familiar with actuarial techniques. In fact, the stock exchange was a place where such techniques had been perfected. Francis Baily, a prominent member of the stock exchange committee, was also pioneer of modern mathematical finance, having authored what was at the time the reference textbook for calculating present values, rates of returns, and for converting capital into annuities (Baily 1808). Such methods were routinely mobilized, for instance, to determine the annuities discharged stock exchange defaulters owed their creditors. And so, knowledge of the financial characteristics of the loan was generally sufficient to establish the precise meaning of ratability.

Against this backdrop, there are limited traces of haggling over relative values – since stakeholders had technical instruments to see eye to eye. For instance, in the minutes of one Spanish bondholder meeting held in 1827, only a few months after the stock exchange statute was adopted, we find a discussion regarding the relative value of the various Spanish debts. One issue was that debts bore the same coupons but they had been issued at different prices creating plausible grounds (according to some) for such investors receiving proportionately smaller compensation. When the concern was voiced, the reaction of the assembly was to push back immediately against it, as it was something that could be dealt with later and left to experts. As the *Times*' account reports, "many gentlemen urged that it was not for the *bonâ fide* creditors under whatever terms of contract, to create invidious and untenable cavils in behalf of the government, which had not as yet repaid a farthing to anybody." In fact the majority opinion was against making "prejudicial or ungenerous distinction" at this early stage.[126]

In other words, the fine print could be left to the technicians who would ultimately adjust the various interests. Judges in the stock exchange committee were knowledgeable of the relevant techniques as they should be since they adjudicated stockbroker failures every week, which involved rubber stamping restructuring formulae. The afore mentioned Francis Baily was a deputy chairman of the stock exchange committee 1811-1814, and also the chairman of the committee that had been tasked with consolidating the jurisprudence of the stock exchange in 1812, leading to the publication of the first printed *Rules and Regulations* of the stock exchange.[127] In fact, the stock exchange committee was a site of expertise regarding actuarial calculations and it could be relied upon for vetting agreements among creditor groups.

[126]"Spanish Bondholders." *Times*, May 29, 1827. Mention was also made of a "moral reason" for upholding parity, viz. that "the dividends of the first loan were paid out of the produce of the second."
[127] See Flandreau & Legentilhomme (2021) for detail.

Other things being equal therefore, *pari passu* status needed not be re-specified in individual sovereign debt contracts. Because it was *presumed* under the statutes of the London stock exchange sovereign debt jurisdiction, it was safe to omit its explicit insertion in covenants – unless there was a good reason to introduce them. To repeat, equal treatment was by right, and what this meant in practice could be deducted from the actual technical provisions in the contract. Against this backdrop, we should not expect, at least originally, a significant use of *pari passu* clauses, though their injection was not ruled out either. A consequence of this is that mining collections of historical contracts as contract originalists have done is not the best way to get to the bottom of the logic of *pari passu* clauses.

This interpretation is supported by an examination of the universe of long term sovereign debt contracts involving fresh capital calls, issued in the London stock exchange 1848-1875. This database, which unlike the one used by Gulati and Scott is exhaustive, contains about 120 sovereign debt covenants. Consistently with my contention, it shows a very limited use of *pari passu* language.[128] What is more, the expression *pari passu* emerges as a kind of short hand, as a manner of summarizing a lengthy description of financial characteristics. For instance, the first case is provided by a March 1850 sterling loan contracted in London by the Kingdom of Denmark. In line with the analysis above, the prospectus used in fact the *pari passu* language as a compact way to communicate the *financial identity* between this loan and a previous Danish loan, issued in London in 1849: The documentation in the media stated that the new loan was placed "on the same footing in every respect as that contracted for in 1849."[129]

The point is this: If two contracts involve the same characteristics, then, a fortiori, they place their respective creditors on an equal footing – and vice versa. Accordingly, reference to equal footing becomes an abbreviation for "financially identical." Sometimes, observers used the expression "synonymous" instead. Therefore, a contract speaking of "same footing in every respect" made reference to rights being not only ratable or proportional, but standing in a proportion of 1:1 against one another in the event of a discharge. In fact, I suspect that, by contrast to the prospectus in the media which has the expression quoted above, the general bond of the Danish loan, which I could not find, also enumerated the characteristics individually. The point is that the prospectus printed in the media (where space was scarce) made reference to equal footing as convenient, transparent and economical language. Another benefit was that, given the success with which we are told the issue of 1849 had been met, this reference to equal footing might have been a form of publicity.[130]

[128] See Flandreau, Pietrosanti and Schuster (2021).
[129] *London Standard*, 18 Mars 1850. I am grateful to A. Gamboa for having drawn my attention to this loan.
[130] I came across another illustration of this semantic use by mining the British Parliamentary Debates. In the context of the discussion of the India Loan Bill of 1859 whereby the transfer of EIC's debt to the British Crown was arranged one MP asked whether the "debentures under this act would rank *pari passu* with those under the Act of

It would be tempting to make of the Church Contract just another incidence of this logic. And to a point it was: The contract mentioned two identical issues, a current one, which was the one on offer and a future one, which the borrower reserved to make later on. The *pari passu* language is found in the bond's article 14, which stated that holders of the second issue, if it took place, would "rank equally with the subscribers of the first issue."[131] As was also stipulated, there would not be any "preference or priority in favor of the Holders of either issue, *both issues being considered as forming one loan*."[132] In other words, the two issues were in a 1:1 relation.

On the other hand, the fact that reference was made to a future, not yet extant issue, renders the Church Contract interesting. The clause reveals the following underlying logic: If under the law of the stock exchange, provisions in contracts informed the determination of relative positions, then grounds existed for using language in contracts to achieve other things.[133] The *pari passu* clauses in the Church Contract offers an illustration of this possibility to fine tune priorities through language. In the instance, present creditors (purchasers of the loan containing the *pari passu* language) *limited their ability to litigate a future issue of the second tranche*. But then more generally it was possible to achieve a lot through contractual provisions, language in contracts becoming a potent instrument to manage priorities.

b) Define Default

Of course, for this to be possible, it was necessary for the stock exchange committee to admit its role in enforcing such complex clauses as written into sovereign debt contracts. As I already stated, under the statute of 1827 the committee was tasked with seeing to it that, before a country was allowed to borrow, there were no pending claims. The original wording of 1827 had identified default narrowly as a situation where the debt instruments of the sovereign had been left "in arrears." This was consistent with the situation back then but, progressively, bondholders trying new grounds found the committee willing to engage. A situation emerged whereby the statute served to enforce virtually anything: Creditors would place themselves under the remit of the statute and require the enforcement of clauses in contracts. A fundamental consequence of

last Session." This substituted for a long enumeration of individual characteristics. Hansard, East India Loan Bill—Committee, Volume 153: debated on Friday 11 March 1859, c. 87.

[131] The first was for £1.7 million and the second for £0.3 million.

[132] My italics. This is the language of Art. 14: "The Republic of Bolivia reserves the right hereafter to make a second issue of the residue of the said amount of Two million pound sterling on the same securities as are herein provided for the Subscribers to the first issue of One million seven hundred thousand pounds and in such event the Subscribers to the second issue are to rank equally with the subscribers of the first issue in their rights to the said securities specified in the 12th Article without any preference or priority in favour of the Holders of either issue, both issues being considered as forming one loan."

[133] Such a possibility is visible, for instance in a Kingdom of Sardinia bond of 1851, where the parity between this bond and the Italian "*Rente*" was stipulated, although the bond had a fixed term while the *Rente* was perpetual. Beyond this, the same "privileges, immunities and favour, [were] accorded to [the holders of] other bonds of the public debt of the State, and especially that of exemption from taxation and seizure." *Morning Post*, July 1, 1851.

this was that functionally, *any violation of a provision in a sovereign debt covenant was construed as default*.

The evolution whereby the legal perimeter of the statute was extended was a gradual process. One instance (striking by the clarity of the discussion it occasioned) is a request in 1854 from Peruvian bondholders to strike down a new Peruvian loan alleging contractual violations. Because Peru was at that point dutifully servicing the interest on its debt, Edward Haslewood, the broker of the loan who acted as counsel for the issuer, declared that the case was nonjusticiable. But the chairman of the stock exchange committee countered that a country not being in arrear was not the only ground for applying the statute, adding that the powers of the committee were "extensive" and "discretionary," and that "in cases where no definite rule existed in the Book of Regulations," the committee would rule on "merit alone."[134] This was a standing invitation for bondholders to attempt and place any perceived contractual violation under the statute, as turned out to be the case. More generally, a situation emerged where the parties aggrieved by any alleged contractual violation would place themselves within the remit of the statute, taking advantage of a new issue to secure redress.

Consistently, new grounds for obstruction were tried and new grounds were admitted. As a result, the stock exchange committee's "docket" filled up with disputes involving various departures from contractual provisions. One example can serve as a case in point. In 1866, a dispute pitted bondholders against the Russian government. The two parties had different interpretations of the mode of amortizing the debt as provided for in Clause 6 of the Imperial Russian Loan, 3 Percent Annuities, issued in 1859 by Thomson, Bonar & Co. The Russian government had amortized the loan by intervening in the market opportunistically, from a fund constituted annually, rather than annually. Taking advantage of the issue of a new loan issued by Barings that year bondholders litigated.[135] The hearings, whose substance is unfortunately heavily condensed, involved David Salomons, veteran of previous sovereign debt disputes acting as counsel for the bondholder protective organization. The committee ruled in favor of the bondholders. Drawing on the custom of sovereign debt amortization, it found that the Imperial Russian Government had given itself more leeway than it really had under the terms of the covenant and asked the Russian government to make the required adjustment. This provides conclusive evidence that clauses in contracts could be litigated and enforced under the statute.[136]

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[134] Chairman Hutchinson, MS14600/23, August 18, 1854, p. 103.
[135] This was the so-called Russian Anglo-Dutch 5%.
[136] For the information in this paragraph, my source is MS 14600/31, Dec 15, 1866, p. 18-19. By contrast, I have not gotten hold of the exact text of the clause under discussion. But from *Morning Chronicle* (9 August 1859), which summarizes the language in the bond, it must have looked approximately like this: "The imperial government will assign a special fund for the annual redemption of this loan of 1.5 percent per annum of the nominal capital invested in the market." Probably reflecting concerns over financial optimization, the Russian government had interpreted this as meaning that while they had the obligation to *provision* the special fund with 1.5 per annum, they were not obliged to *redeem* the debt annually. As the committee ruled unanimously, however, "the obvious and generally accepted meaning of the conditions of the three percent loan is, that the purchases for the Sinking Fund, should be

The stock exchange's demonstrated readiness to enforce a broadening range of provisions in turn encouraged a complexification of the provisions. Evidence of this is provided by a discussion that occurred in 1865, during a bondholder assembly gathered to vote on a discharge for the Republic of Honduras. The bondholders were not completely happy with the offer made by the representatives of the country, leading one of the managers of the meeting to craft the motion to be communicated to the stock exchange in the following way: The discharge would be "conditional" that is, unless Honduras improved the terms (offered a smaller debt write-off), they would only authorize new issues to the extent that they would *not* be put "on the same footing" as the converted old bonds. This could only mean one thing: That new loans by Honduras would have to stipulate that they would not enjoy *pari passu* standing, in fact recognizing the priority of former creditors. The manner in which this would be enforced would be by litigating new issues that would violate this provision. And the grounds for the litigation would consist in showing to the stock exchange committee the Honduras bondholder's motion, that they had only authorized the discharge conditionally on their being given absolute priority.[137] What this strategy reveals is that bondholders *expected the committee to enforce a broad array of contractually stipulated priorities*. Here, it adds perspective, to say that the activist who had suggested the strategy was Edward Haslewood, the same individual we encountered when the stock exchange committee asserted its broad powers in interpreting the statute. Obviously, Haslewood had learned the lesson.

The evolution in the jurisprudence was eventually consolidated by a rewording of the stock exchange's original discharge statute. This occurred in 1870 at the behest of the Committee for Rules and Regulations, a sub-committee of the stock exchange committee. While little is known of the reasons that prompted the adjustment at this precise juncture, one interpretation is that this was a period of intense activity in sovereign debt origination and that, as a result, the stock exchange tribunal was coming under pressure to clarify its doctrine. Under the new wording, the definition of actionable contractual breach involved *any* violation of contractual stipulation: Indeed, creditors would be able to litigate the issues of "any Foreign Government that *violated the conditions* of any previous public loan."[138] This broadening of the scope was useful because

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made annually." For interesting follow up, showing how on the back of subsequent bond issues the committee assisted the bondholders' efforts with ensuring that Russians would make their efforts to abide by the ruling, see MS 14600/31, June 17, 1867, p. 235; and *Morning Post*, June 18, 1867; MS 14600/31, Nov. 11, 1867, p. 386-7; MS 14600/32, Dec. 18, 1867. The episode attracted significant attention at the time. It led to a later account in Charles Duguid who refers to it as "The House v. Russia" in his popular history of the London stock exchange (Duguid 1901, p. 187 ff.).

[137] *Morning Post*, August 25, 1865. Of course, issuing a junior loan would be difficult, and this spelled the collapse of the Honduras attempt, and the discharge went back to the drawing board, which might have been the calculation.

[138] My italics. The original wording, excluding any sovereign "that has not duly paid the dividends on former loans" still appears in the 1868 edition of the Rules and Regulations (Slaughter 1868, p. 33). For the 1870 modification see MS14612/1 and MS 14600/34 ;and Change proposed by the committee for rules and regulations, a sub-committee of the stock exchange committee, ratified by the stock exchange committee on July 26, 1870. On June 7, 1870, the amendment of the language of the statute came under discussion, with a motion to alter the terminology:[58] "The

instead of constraining litigators through precedent, it led to secure expectations that any departure from contractual provisions might be litigated, with predictable results, provided that the language in contracts was clear. This encouraged the creative accumulation of stipulations, conditions and clauses by borrowers and lenders alike.

c) Litigating *Pari Passu* Violations: A Case Study

The conclusion of the previous discussion is that by 1870, the stock exchange discharge statute had become the basis for legal-financial engineering. In fact, literally before the ink used to draft the 1870 stock exchange statute revision had dried, a Peruvian loan was floated in London with a clause that availed itself of the logic described above. Article 5 of the Government of Peru Six Percent Consolidated Bond gave lenders what may be described as a "most favored creditor status" in fact a variant of *pari passu*. Creditors were promised to never be more poorly treated than any other future creditor class. In practice this was achieved by stipulating that "no other Loan can under any circumstances take precedence of these bonds."[139] Presumably, the drafters of the contract were wary of a future attempt by the Peruvian government to dilute their rights and the clause was introduced preemptively. The clause was meant to work as follows: Should such an attempt indeed materialize, holders of the 1870 Government of Peru Six Percent would be able to litigate the new loan before the stock exchange and get it struck down.

Indeed, litigation – or rather, threat of litigation, leading to the adjustment of the terms of the loan – did follow in the Spring of 1872, when Peru issued a new 5% Bond ("Government of Peru 5 Percent Consolidated Loan"). In its original wording, it had stipulations which some 1870 bondholders believed was in violation of the most favored creditor clause in their Article 5 of the loan of 1870.[140] In letters to the Council of Foreign Bondholders and to the Stock Exchange Committee, they raised objections against the new issue. The first charge was that Art. 6 of the new loan gave as security a group of railways already pledged to 1870 bondholders, without referring to the rights of 1870 bondholders as if, precisely, the bondholders of 1872 were taking

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Committee will not quote in the official list New Bonds or Stock, or any other Securities issued by any foreign government, that has violated the conditions of any previous loan raised in this country, unless such government shall have satisfied the claims of its creditors." After postponing several times the discussion of the motion, it was finally withdrawn by the deputy chairman, on July 7, 1870, "with the understanding that the matter would be again brought forward in a subsequent occasion." It came back on July 26, 1870, with the following wording, which was carried unanimously: "The Committee will not sanction or recognize New Bonds, Stock, or other Securities issued by any Foreign Government that has violated the conditions of any previous Public Loan raised in this country, unless it shall appear to the Committee that a settlement of existing claims has been assented to by the general body of bondholders." This language is the one that appears in the 1873 edition of the *Rules and Regulations* (Slaughter 1873, as Rule 59).

[139] Text of prospectus from *Times*, June 4, 1870. "Government of Peru, Issue of 11,920,000 sterling nominal capital, six per cent."

[140] It is unclear that the violation had been deliberate. It seems to have resulted from the fact that it had been initially considered that the 1870 bonds would be converted into new 1872 bonds, but the conversion was aborted because the powers to effect it were not adequate. The result was linguistic ambiguities, affording the opportunity to observe the importance of language.

precedence.[141] The second charge was that while the loan of 1870 deferred amortization until 1880, the loan of 1872 provided for an immediate 2% per year sinking fund. This would give 1872 bondholders de facto priority, since their claim would amortize faster. One protest filed with the stock exchange committee put the matter as follows (underlined and crossed out language in original): The Article 5 in the 1870 bond provided that "'no other loan can under any circumstance take ~~priority~~ precedence of this bonds' […] Now, it surely requires no lawyer to explain the word precedence, and I think that common sense must allow that by issuing a new loan with a 2% sinking fund […] you are giving a priority over a loan which has only a sinking fund that commence in 1880."[142]

The result was intense bargaining in anticipation of the stock exchange clearance, a recognition of the ultimate power which the committee had over the terms of the contract. In the instance, the rights of 1870 bondholders were represented by the Council of Foreign Bondholders (which at that time did not yet fully monopolize the defense of bondholders). In a letter to bankers representing the issue, Shroeders & Co, they suggested amicable wording changes that would address the two concerns of their "constituents." First, they asked that the general bond for the loan of 1872 should acknowledge formally the rights of 1870 bondholders.[143] The bankers were happy to oblige although they did point to another clause (Art. 8) in the new contract, which in their view did "amply provided" for the rights of 1870.[144] The other charge – that the 1872 amortization scheme favored the new creditors at the expense of most favored 1870 creditors and thus was a contractual violation – was also the object of linguistic clarification. Consistent with their effort to keep an amicable approach, the Secretary of the Council of Foreign Bondholders informed the issuers of their conclusion that, in fact, it seemed that the new loan had provided for a bonification of the position of 1870 bondholders, though this was cast in a terse way, for which

[141] Stock Exchange Applications, Peruvian Government 5% Consolidated, 153.1.B., General Bond. For the discussion of the issue before the stock exchange committee, see MS 14600/36; p. 162-177, April 30-May 9, 1872. Art. 6 in the initial language read as follows: "As a guarantee for the fulfillment of the obligations in this Bond, the Government of Peru […] pledges all the Stocks of Guano of the Republic, especially those of the Islands of Guanape, Macabi, Ballestas, Lobos, Bahia do Independencia, Pabellon de Pica, [etc.] subject only to the Contracts in force relating to the Government Loans of 1865, 1866 and 1870, and the guaranteed Pisco-Yca Railway Loan of £290,000. The Supreme Government of Peru also pledges the property of the Railways from Arequipa to Puno, from Meija to Arequipa, from Callao to la Oroya, as also all the lines that have to be connected with the proceeds of the present loan, and the proceeds of the working thereof [etc.], and generally all the Revenues of the Republic." For the Council of Foreign Bondholders the contentious wording was the omitted repetition of the formula "subject only to the contracts […] of 1865, 1866 and 1870" in the second sentence referring to the Railways from Arequipa to Puno, from Meija to Arequipa. The language of the prospectus had been even more imprecise. It only spoke of the fact that holders of the loan of 1870, who were in the original arrangement given the option to convert their bond in the new title, would retain their "rights and privileges." See *Evening Standard*, March 20, 1872 for the exchange between the CFB and the contractors.
[142] Peruvian Government 5% Consolidated, Stock Exchange applications, 153.1.B. R. Reeding; Letter to the Committee of the Stock Exchange, April 24, 1872.
[143] Note that the problem was not the repledging of the same security but the omitted mention of the rights of the 1870 bondholders in the 1872 prospectus.
[144] Letter from Council of Foreign Bondholders to contractors and response by contractors, *Daily Mail*, April 16, 1872.

they required clarification. There again, they received confirmation from Shroeders & Co. Holders of the bond of 1870 would enjoy immediate amortization. This is a remarkable result because it implied that indeed, in compliance with their status as most favored creditors, 1870 bondholders were benefited by an *improvement* compared to the original terms of their contract. What is more, this improvement was the outcome of the right to litigate a new issue.[145]

In other words, fear of litigation had led the parties to settle out of court, so that when the matter circled back to the stock exchange the committee could focus on helping the parties formalize their newfound agreement.[146] The committee delivered a verdict favorable to the new loan, conditional on two adjustments. It required, first, the change in the language in the general bond in the new loan, acknowledging the precedence of the loan of 1870.[147] Second, the committee required the contractors to produce what they described as an "undertaking" stipulating that the immediate amortization of 1870 bonds would be duly carried out. Three days later, the said certificate was sent in and the loan was signed off.[148] Evidence shows that amortization of the 1870 loan would indeed begin that year, demonstrating that the pledge had been carried through.[149]

This case study shows two fundamental points. First, contemporary investors, bankers and legal actors were paying very close attention to contractual provisions. This makes sense, since they could be litigated before the stock exchange and thus create advantages or difficulties. Second, it demonstrates once again that the *pari passu* logic in sovereign debt covenants translated into ratable payments. As the plaintiff had put it, it surely required no lawyer to explain the word precedence, and if one bond enjoying most favored treatment was to be crowded out by a subsequent one, then a contractual violation would have occurred. What was needed was an improvement in the actual payout, here, the amortization. In the end, with the support of the stock exchange committee, 1870 bondholders were kept on an equal footing with the new lenders.

d) The Making of the Church Contract

Although Gulati and Scott declare being unable to figure out the reasons for the *pari passu* clause in the Church Contract, the previous discussion provides all the elements to make sense of

[145] *Daily Mail*, April 16, 1872. The letter mobilized language found in both the prospectus and the general bond. The prospectus is available from *London Standard*, March 20, 1872.
[146] The hearing involved the various parties. A partner from Shroeders & Co, Henry Frederic Tiarks, came in person. Edward Haslewood was also heard, and he voiced additional obstructions in his own capacity.
[147] In the chosen formula the new loan was "subject to the existing contracts in force relating to the said Loan of 1870 (so far as such contracts affect the same [securities] respectively)." In addition, as a result of this change in contractual provisions, early subscribers to the loan were given the right to opt out of "scrip" at no cost for them, contrary to what was specified in the prospectus.
[148] MS 14600/36; 6 May 1872, p. 176-7. A "long conversation" had preceded the vote of 11 against 6.
[149] MS 14600/36; 6 May 1872, p. 171. For evidence that the buybacks were duly implemented, see *Investor's Monthly Manual*, December 1872, which shows them for a total of £400,000.

them. It should come as no surprise in particular that this *pari passu* provision appeared on the heels of the developments and litigation just narrated. In fact, the *pari passu* clauses in the Church Contract can be rationalized as follows: The Bolivian government had received an authorization from its Parliament for a loan of up to 2 millions pounds. Based on the calculations made at the time however, it had been thought that 1.7 million pounds would cover the cost, leaving a balance of 300,000 pounds. In case of cost overrun, the balance might nonetheless turn out to be necessary and if it were called in, it was necessary to clarify each creditor group's rights.

This clarification was rendered even more necessary because of additional features of the project. The project helped fund the construction of a railway and navigation company to throw Bolivia open to foreign trade via the Amazon. The companies would operate under government franchise and the revenues of the Navigation Company would accrue to bondholders in case of non-performance of the loan.[150] In fact, the loan to Bolivia was only one element in a complex web of contracts that structured what amounted to a debt-equity swap contingent on default. As a result, a possible rivalry between present and future bondholders was created, in a manner functionally similar to the one that emerged in the Peruvian situation above. Given the manner in which the stock exchange ruled on such matters, the risk of an obstruction was material and it would ultimately interfere with the promoters' efforts to complete the line. One way to deflect this risk was to make sure that investors in the first tranche would forfeit their obstruction rights.

The remedy was the *pari passu* provision discovered by Gulati and Scott. It sorted the litigation conundrum by clarifying the respective rights of the two creditor classes. In practice, 1872 bondholders granted Bolivia the option to issue the second tranche.[151] Next, the general bond stipulated, as we saw, that the two classes would rank equally and that both issues formed, in fact, but one loan with the exact same rights: Together, this amounted to having investors in the first tranche give away their right to vet the subsequent issue, the ultimate effect being to secure unattached funding for the completion of the project. If a stock exchange dispute nonetheless occurred, the defendants (the promoters of the project as issuers of the second tranche) would only need to point out that the plaintiffs (the holders of the first tranche) had, by the very act of subscribing, assented to the terms of the general bond, forfeiting the obstruction right they would normally own under the rules of the stock exchange.[152]

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[150] The language used was that the "Republic of Bolivia reserves the right to make an issue of the residue of the said amount of Two million pounds sterling." See General Bond, Art. 12, 3rd. Anonymous (1873).

[151] General Bond, see Anonymous (1873).

[152] Interestingly, though in a completely different way than in corporate law, this shows that the law of the stock exchange was coming very close to doing something which Buchheit and Pam claim was impossible in the 19th century: Enforcing the collateral in a bankruptcy. Needless to repeat, the stock exchange committee had no repossession authority over foreign railways, etc., but it had authority over payments and priorities. Because rights could be mapped into intangible "securities" it was valuable for creditors to specify these securities in contracts, because that would enable them to coordinate with the help of the stock exchange committee.

Many clues were left along the way enabling historians to conclude safely that the actions of the contract drafters were *deliberate.* The loan to Bolivia was part of a web of contracts conceived by Philip Rose, from Baxter, Rose, Norton & Co., a leading London law firm with extensive interests in infrastructure finance and sovereign debt, who was working for the financier who arranged the funding operation, Baron Erlanger.[153] Rose was himself a prominent lawyer, agent for the Conservative Party and the personal attorney of Conservative party leader Benjamin Disraeli.[154] He was closely related to the sovereign bondholder milieu, having designed in 1868 the Foreign & Colonial Investment Trust, a sovereign debt investment fund and the first investment trust ever.[155] What is more, he was appointed in the first committee of the Council of Foreign Bondholders in 1868, while his law firm became one of its two counsels in 1872. So this means that he was involved in the CFB during the Peruvian litigation episode in 1872.

But Philip Rose was not alone: The formal figurehead of the whole operation, George Earl Church, had insider knowledge of the legal functioning of the stock exchange. Though exact circumstances are unknown, he was in close contact with Edward Haslewood. This stockbroker, whom we came across several times already, was a bondholder activist and a leader of the Spanish American Bondholder Association; As a result he was a regular litigator before the stock exchange jurisdiction as already emphasized. Not only had he published in 1866 a pamphlet on the economic value of opening Pacific-facing countries of Latin America to Atlantic trade via the Amazon, but he had the required financial knowledge.[156] Haslewood appears as one of seven promoters of Church's railway company and was main shareholder of Church's Amazon navigation company, too. In fact, I suspect that this routine user of the stock exchange court of sovereign debt justice was the real mastermind of the Church Contract.

Given this, it is not really a big stretch to conclude that, behind the Church Contract was a group of financiers with experience in sovereign debt, and in particular with the law of the stock exchange, who had banded together and combined their skills to design the product in question. In particular, the contract reflected their predictions regarding the kind of verdict the stock exchange would return in the event of a dispute. Whatever the exact details – and this part is unimportant – the Church Contract is far removed from having been the accident depicted by the originalist school. It came about as a result of the actions of individuals who knew very well what they were talking about. It mobilized the powers of a jurisdiction, which they not only

[153] On Rose & co, see St George (1995); As shown by St George (1995) Rose was "embedded" in the 1870s with the House of Erlanger the underwriter of the Church Loan. On Erlanger see Lobban (2006).
[154] This is not anecdotal. In fact, Disraeli had old and close connections among foreign debt activists. John Diston Powles, the perennial chairman of the Spanish American Bondholder committee had employed Disraeli when he was a young journalist in the 1820s to puff up foreign loans, and the two men had remained in touch until the death of the latter. See Flandreau (2016, passim).
[155] The F&C was created in 1868, Scratchley (1875); McKendrick & Newlands (1999); Chambers and Esteves (2008).
[156] Haslewood (1863); On the connection between Church and Haslewood, see Flandreau (2016).

understood but *used*. With this accumulation of evidence, how could one continue to argue that *pari passu* provisions in the Church Contract cannot be elucidated, that they were the product of fancy, a random boilerplate proposed by either hurried or semi-competent corporate lawyers, a virus that jumped species, the departure point of an infernal invasion of clones, and that nothing justified?

PART VI. CONCLUSION: THE FABLE OF CLAUSES

In a methodological post-script to their investigation of *pari passu* clauses in sovereign contracts, Buchheit and Pam ruminate the challenges of historical inference. They liken their attempt to sample contracts to the dipping of a "small bucket" in a broad ocean. When dipped, the bucket brings back contracts whose language, with some interpretative work, enables us to tie to one another and to their context. Subsequently, Gulati and Scott and others have sought to industrialize the bucket approach and pumped the ocean to construct a dataset. But what either method could never bring up is what was not in the ocean in the first place. As I have shown, 19th century sovereign debt contracts drafted then were informed by the debt discharge techniques developed by a sovereign bankruptcy jurisdiction, the London stock exchange, the governing body of what was indisputably at the time the main capital market in the world.

This article has exhumed from the depth of a so far unexplored archive the foundations of a full-fledged sovereign bankruptcy regime. In so doing it has also demonstrated the agency of creditor priority rules in the management of a discharge statute and jurisprudence. It has traced the origins of this regime, not to corporate law but to a quaint body of legal knowledge, the law of stockbroker bankruptcies whose creation had been rendered necessary by the illegality of stockbroker activities. Eventually this jurisdiction became the admitted court for sovereign default, one that was recognized as such by foreign governments who could benefit from the available expertise to conduct capacious debt restructurings. The crowning piece of the London stock exchange discharge was the extension of a clean slate, freely negotiated among parties. No wonder that many borrowers and lenders wanted sovereign debt to be issued under the jurisdiction of the London stock exchange.

In the light of history therefore, it does not appear absurd at all to say that *pari passu* clauses have been introduced with an eye to securing ratable distributions. This is undeniably true in a meta-historical way: Under the early regime where they first appeared, *pari passu* provisions were introduced indeed precisely with this intention – in anticipation that departure from ratable distributions would be litigated under the discharge statute of the London stock exchange. If modern contract drafters could not have in mind the precise machinery of the by now deceased London stock exchange's jurisdiction they could have had in view the possibility that some court, someday, would hear them. They may also have had in mind the point I have made earlier, that, if sovereign bankruptcy is ever to be implemented then it will have to begin with ratable

distributions. Against this backdrop, the clauses became a way to secure protection preemptively, "just in case," a barnacle expecting to find its whale.

To a theoretically minded economic historian, this bizarre detour which the history of sovereign bankruptcy took through the bankruptcy of stockbrokers involved in illegal bargains cannot be coincidental. In fact, it holds a fundamental message. The fact that sovereign bankruptcy has roots in a strange, off-shore jurisdiction, designed in the final stages of the Early Modern Era underscores the originality of sovereign default and the need to conceive it on its own terms.

Against this backdrop, the case against modern *pari passu* verdicts is really the charge of normative lawyers against modern courts of justice for having had the arrogance to play god and interfere with sovereign debt restructurings. But this interference had itself been made possible by the fact that absolute sovereign immunity had given way to its modern, qualified variant, inviting the formal judiciary back into the bankruptcy process. Against the backdrop of increasingly limited sovereign immunity, we can interpret the attitude of modern courts as an attempt to seize a new jurisdictional power, an attempt, in fact, to try and administer a kind of fragmented bankruptcy.

Continuing along the same logic, this article has proposed to reinterpret the modern debate on *pari passu* clauses as being really a debate about sovereign bankruptcy. The discussion has, in fact, cast contract originalists in a tradition that goes back to the attitude of British international lawyers and law officers such as Phillimore who emphasized that national bankruptcy was an absurdity because it was impractical. Like these predecessors, modern contract originalists have scoffed at the idea of national bankruptcy, leading them to deride modern courts trying to enforce *pari passu* distributions. A more valid criticism may be that modern courts trying to adjudicate bankruptcy in a fragmentary, piecemeal way is not efficient. But I note that the *pari passu* verdicts that were returned, far from causing the disappearance of *pari passu* clauses, have led to the propagation of counteracting provisions in sovereign debt contracts, such as collective action clauses. I also note that the alternative proposed by the IMF in the shape of a sovereign debt bankruptcy venue can be read as yet another attempt to reinvent the archaic arrangement, this time by drawing on the strength of inter-governmental cooperation.

To elucidate more fully these fascinating modern evolutions, we would need to reconstruct more fully, too, sovereign bankruptcy's historical arc. The present article has undertaken this urgent task, and regardless of the limitations of my approach, I hope to have made a compelling case that when it comes to sovereign bankruptcy and clauses in sovereign debt contracts, the half has not been told. Pending the continuation of research efforts along the lines I have pioneered, let's just say that the question at hand from now on is no longer to explain why a misplaced contractual clause propagated by rote in the sovereign debt boilerplate as contract originalists have asserted. It is why an incorrect reading of the meaning of *pari passu* clauses – nothing less

than the oversight of a fully functioning sovereign discharge regime – propagated by rote in the sovereign debt literature, ultimately obfuscating the fact that sovereign bankruptcy law has historical origins, to which the emergence of *pari passu* clauses is closely tied.

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