Violating Impartiality: The United States Judiciary Governing the Market

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Abstract

Sovereign debt markets have, historically, been formally unregulated, but with the advent of the 1976 US Foreign Sovereign Immunities Act (FSIA), this is no longer the case. Sovereign states can now be sued in US courts. As a result, US judges have gained a considerable amount of power over how sovereign debt defaults are resolved. Although a reasonable expectation would be that the majority of cases are won by plaintiffs because the evidence that a state—the defendant—defaulted is clear, this does not occur in practice. What affects the decisions judges make? I argue that a judges' ideological inclination affects their decisions. Conservative judges, unlike their liberal counterparts, are more likely to rule against the defendant because they want to enforce free market norms. This difference in ruling propensity is most acute when the defendant is a democracy as they have close economic ties with the US. I test my argument with an original data set of US sovereign debt litigation cases that covers the period between 1976 and 2019. Using Bayesian hierarchical modeling and Virtual Twins, I demonstrate that the outcome of a case is influenced by (a) whether the case is assigned to a liberal or conservative judge, (b) the strength of economic ties between the United States and the debtor state, and (c) the level of democracy in the defendant country. Despite expectations, plaintiffs do not regularly win. This study has implications for understanding the evolution of international debt market governance in a period where banking houses, such as the Rothschild's, no longer exists.

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Introduction

In an Opinion issued on July 8th, 1983 in the case of Allied Bank International vs. Costa Rica, Judge Griesa stated that he would not rule in favor of the plaintiffs (Allied Bank International) despite the evidence against Costa Rica. According to Judge Griesa, "The essential facts [of the case] are not in dispute" because the Costa Rican government did stop payments to creditors and did default.[1] Based on facts, Allied Bank International should have won this case, but yet, they did not. Why did Judge Griesa not rule in favor of the plaintiffs if the facts were clear? What affects the decisions judges make?

Since the advent of the 1976 Foreign Sovereign Immunities Act (FSIA), US judges, like Judge Griesa, have the ability to make default costly by (1) forcing a country to repay all of its creditors and/or (2) by preventing a country from re-entering the market by issuing orders that permits creditors to seize its assets. In many ways, US judges play a similar role to that of the Law Merchant (LM) during the Middle Ages (Milgrom, North, and Weingast, 1990). With an LM, one party in a trade deal can accuse the other of cheating and file a claim, which then the LM adjudicates in an honest manner. The purpose of the LM is to settle disputes, impose sanctions, and to provide information. These are also functions that US judges provide in sovereign debt disputes.

However, while Milgrom, North, and Weingast (1990) contemplate the possibility of corruption among judges, they do not consider ideological preferences. Preferences have a role in influencing outcomes. In his explanation for his decision to not rule in favor of Allied Bank International, Judge Griesa stated that he was concerned about US foreign policy because a ruling for the plaintiffs would suggest that the defendants—in this case, three Costa Rican state-owned banks—should have ignored the mandate of their government and pay the creditors. In other words, a ruling would violate the sovereignty of Costa Rica. Griesa specifically says that "Such an act by this court risks embarrassment to the relations between the executive branch of the United States and the government of Costa Rica".[2] Nevertheless, although Griesa considered US interests, his decision was ultimately reversed upon the intervention of the US executive branch. The US executive branch joined this litigation case as amicus curiae to inform Judge Griesa that he was mistaken in his beliefs about relations between Costa Rica and the US. The Judicial branch was informed that the "…United States has an interest in maintaining New York's status as one of the foremost commercial centers in the world…[creditors] may assume that, except under the most extraordinary circumstances, their rights will be determined in accordance with recognized principles of contract law."[3] For this reason, the decision by Judge Griesa was reversed and Allied Bank International won its case against Costa Rica. This case—one among many—highlights how sovereign debt litigation

[1] *Allied Bank International v. Banco Credito Agricola, 566 F. Supp. 1440.* (1983)
[2] *Allied Bank International v. Banco Credito Agricola, 566 F. Supp. 1440.* (1983)
[3] *Allied Bank International v. Banco Credito Agricola, 757 F.2d 516.* (1985)

case outcomes may not be decided upon in an impartial manner.

While politics has always played a role in sovereign debt from the decision to take on debt to default resolution, the regulation of sovereign debt markets has changed over time. Unlike the trade arena that has the World Trade Organization with its Dispute Settlement Body, there is no equivalent in the finance arena. In fact, international financial markets have historically lacked a formal method of regulation and instead has persisted on informal methods that relies on the role of reputation (Tomz, 2007) or banking houses such as the Rothschild's (Polanyi, 1944). However, the arguments that solely rely on the role of reputation or banking houses for regulation apply to a period where the US judiciary played no role in adjudicating disputes between creditors and debtors and banks were the main actors involved in the bond market. These conditions no longer hold. Beginning in the late 1970s, the role of banks in sovereign lending began to steadily decline and hedge funds, through the purchasing of bonds, have since replaced them as the primary creditor. In their role as primary creditor, these non-state actors have been taking sovereign states to court. With the passing of the FSIA, the US judiciary provides a more formal method of regulating debt markets than was available in the past. For this reason, it is necessary to consider how decisions are being made. What influences who wins?

In this article, I argue that conservative judges will rule against the debtor state (the defendant) to enforce free market norms. However, two conditions must be present for a conservative judge to be more likely than a liberal judge to rule against the defendant. First, there needs to be economic ties between the defendant and the US in the trade arena. If the US is in a trade competition relationship—the degree to which two countries trade the same products—with the defendant country, a judge is more likely to rule against the defendant out of concern that a broken contract in the sovereign debt arena will spillover into the trade arena, which, in turn, will lead to increased tariffs and expropriation. Between conservative and liberal judges, it is conservative judges who would feel most strongly about protecting the interests of US investors. This is because a left-right divide exists among judges as presidents nominate judges that they believe have similar beliefs to their own. Conservative judges are more likely to rule in favor of the plaintiff due to nationalistic concerns and a desire to maintain stability in the global economy. Rulings against the defendant protects the reputation of the US as a leader of the financial system as investors have confidence that their investments have some protection.

Second, the defendant must be a democracy. Democracies have an advantage in sovereign debt litigation cases just as they have advantages when entering the sovereign bond market. Absent the presence of close economic ties with the United States, plaintiffs are more likely to lose when the defendant is a democracy. This is due to international comity—a discretionary doctrine that permits a judge to dismiss a case out of respect for the sovereign state defendant—and the presence of checks and balances. The

presence of multiple veto players and a court that has a similar respect for the rule of law to that of the US lends credibility to the decision of the defendant to default as there was likely to have been veto players against the decision to default. From the perspective of a judge, a default in a democracy will only occur when it absolutely must, which is why they are likely to dismiss the case and permit the default decision to remain a domestic issue.

However, there is a group of countries that are in a trade competition relationship with the United States that are also democracies. I argue that the propensity for liberal and conservative judges to rule in different directions continues even with democracies as defendants. Although democracies have better property rights and rule of law, these factors do not mitigate the importance of free trade and stable economic policy for conservative judges. While the importance of maintaining an open global economy outweighs the regime characteristics of the defendant country for conservative judges, liberal judges will extend international comity to democratic regimes. For this reason, the greatest difference in propensity to rule against a defendant between conservative and liberal judges should be seen among defendants who are democracies.

I support these arguments with two quantitative approaches. First, as the data is hierarchical in nature with defendant, plaintiff, and judge level variables, I use Bayesian hierarchical modeling to examine what influences the outcome of a case. Second, I exploit the quasi-random assignment of judges to cases to attain the overall and subgroup treatment effect of a case being assigned to a conservative or liberal judge. I do this by utilizing Virtual Twins, which is a predictive method that combines machine learning and causal inference.

Using these approaches, I find that conservative judges are more likely to rule in favor of the plaintiff when the defendant is a democracy. While differences in ruling propensity between conservative and liberal judges is lacking across the whole sample, impartiality exists when assessing the role of economic ties and regime type. From the Bayesian model, it is evident that the higher the trade competition a defendant country has with the United States, the more likely it is for the plaintiff to win. It is also the case that a plaintiff is less likely to win as the level of democracy in a country increases. However, Virtual Twins detected a group of highly democratic countries that are more likely to be ruled against if a conservative judge instead of a liberal judge oversees the case. Overall, although one would expect plaintiffs to win regularly, as the facts surrounding a sovereign debt default are hard to dispute, plaintiffs do not always win.

The Importance of Sovereign Debt Litigation

Scholars of sovereign debt have long grappled with the question of why countries repay their debt. A prominent explanation rests on the notion of reputation. Eaton and Gersovitz (1981) put forth the argument that those who default at time t may be excluded from the debt market in the future at $t + 1$. With the assumption that exclusion from the market is permanent, the amount of credit a country can attain depends on the lenders' perception of a country's desire to not be excluded from the market. For this reason, reputation is important. Tomz (2007) expands on Eaton and Gersovitz (1981) by examining three types of states—those who either (1) service debt in good and bad times (stalwarts), (2) service only in good times (fairweathers), or (3) default regularly when times are bad and sometimes in good times (lemons)—and how lenders use the information about these three types of states as it accumulates over time to determine borrowing rates. Lenders will lend to reliable states, so governments want to have a good reputation for repayment. Building on this reputational theory, Jerome Roos (2019) argues that there are three enforcement mechanisms that must be present to prevent default. To prevent default there must be creditors who will sanction a defaulting country by withholding future credit and investment, conditional lending by the IMF, and political and business elites within the debtor state who advocate for debt repayment. The first and third mechanism in particular relies on reputational costs for the debtor state in order for the sanction to be a credible threat. Although reputation is critical to understanding the politics of sovereign debt, the role of US courts has been absent from this line of work.

Diverging from the reputation based theory, Bulow and Rogoff (1989) argue that it is not reputation, but direct sanctions via domestic courts that are the primary motivation for countries to repay their debt. This is because of the link with trade. In their theory, when a country defaults on foreign loans, conducting trade becomes difficult because (1) a country risks having assets seized by creditors awaiting payment on the defaulted bonds and (2) they will be prevented from taking on more debt—that helps fund trade and investment—until the current debt crisis is dealt with. Hence, trade will decline rapidly in the event that there is a default that leads to a direct sanction via domestic courts. Bulow and Rogoff (1989) qualify this argument when discussing US interests. If the debtor is a state with close trade ties to the US, then that state will not experience the negative consequences of default. Instead, it will be US citizens footing the bill for a default in a state that the US trades heavily with.

Following Bulow and Rogoff (1989), much of the recent literature attempts to estimate the effect of sovereign debt litigation on trade. Using the legal saga of the Argentine crisis, Hébert and Schreger (2017) examine the relationship between default probability and the legal rulings in the case of the Republic of Argentina vs. NML Capital on various trade channels. They argue that legal rulings in the case gives information to those participating in the market, which, in turn, affects the probability of default. In fact,

they find that a 10% increase in default probability leads to a 6% decline in Argentine equity value. Hébert and Schreger (2017) then attempt to determine whether it is exporting firms, importing firms, or foreign-owned firms that are most negatively impacted by an increase in default probability. Their evidence suggests that foreign-owned firms, exporters, banks, and large firms are hurt more by an increase in default probability than small importing firms.

From the literature it is evident that sovereign debt may have a large impact on the economic management of a country which, in turn, affects the domestic politics of a country.[4] Yet, the politics of sovereign debt litigation is often missing from discussion, which is problematic as it reveals problems with applying the standard reputation model to understand sovereign debt politics today. Unlike in the past where creditors were large entities that coordinated with each other in the event of a default, today creditors are dispersed, which makes collective action to sanction a debtor state more difficult.

After the 2001 Argentine default, several hedge funds—like NML Capital—purchased the defaulted bonds and did not join the other bondholders in the 2005 and 2010 restructurings. Instead of participating in the restructurings, these hedge funds—often referred to as "Vulture Funds"[5]—sued Argentina in US courts.[6] In response to this suit, Judge Griesa issued a ruling that prevented Argentina from paying the creditors involved in the 2005 and 2010 restructurings until the holdout creditors began to receive payments from Argentina as well. The Argentine government, headed by Cristina Fernández de Kirchner, refused to make payments to the holdout creditors despite the fact that the payments were small relative to the Argentine economy as a whole.[7] As a result of the refusal to settle with the holdout creditors, Argentina did not and could not re-enter capital markets. If Argentina attempted to re-enter the market, they ran the risk of having assets seized as Judge Griesa granted hedge funds their attachment order requests.[8]

Ongoing court cases can prevent a country from entering the market.[9] In the case of Argentina, even though they settled with creditors in two restructurings, they did not re-enter the market until 2016 when the new government—voted in on a policy platform aimed at settling with creditors and ending the legal saga—agreed to settle with all creditors. In fact, weeks after settling with creditors, Argentina issued a 16.5 billion dollar bond, which was Argentina's first issuance since the 2001 default. It was US courts

[4] See Tomz (2007); Stasavage (2003); Van Rijckeghem and Weder (2009); Saiegh (2009); and Kohlscheen (2010) for a discussion about the domestic politics of sovereign debt in democracies and for the authoritarian case, see Ballard-Rosa (2016).

[5] Vulture funds are hedge funds that buy bonds that a country already defaulted on and then take that country to court in hopes of gaining a large profit from the defaulted bonds. Vulture funds are often based in the British Virgin Islands and other tax havens.

[6] They were able to sue in US courts because the debt was denominated in US dollars and issued under New York law.

[7] This is why Hébert and Schreger (2017) believe that rulings in favor of the creditor (NML) would increase the likelihood of default and rulings in favor of Argentina lowered the likelihood of default.

[8] Attachment orders permits hedge funds to seize the assets of a sovereign to recoup losses.

[9] Studies have found that countries do not enter the debt market while a case is going through the court system. See Schumacher, Trebesch, and Enderlein (2018) for an excellent description of how sovereign debt litigation prevents countries from re-entering the market.

that prevented Argentina from re-entering the market after its 2010 restructuring. For this reason, judicial decision-making should be examined in the sovereign debt context.

The Advent of the US Judiciary as International Regulator and the Ensuing Puzzle

The US judiciary gained the power to make decisions relating to economic events in other countries in 1976 with the passing of the FSIA. Before the 1976 FSIA, an enforcement device for creditors against governments was lacking and, due to sovereign immunity, a foreign government could not be sued in US courts.[10] Without the FSIA, the only choice creditors had was to either accept the loss from a default, enter restructuring negotiations, or to pressure their home governments to get involved[11] because a country is not a corporation. When a government defaults it cannot be sold off to help investors recoup some of their loses. There is no liquidation.

The FSIA permits agents to sue a foreign entity in US courts as long as the dispute involves commercial activity, US property, expropriations, noncommercial torts, enforcement of arbitral agreements, and maritime liens that have substantial connection to the US. For example, a hedge fund based in any country that purchased Argentine bonds denominated in US dollars can then sue Argentina at the United States District Court for the Southern District of New York[12] if Argentina does not pay them in the event of a default. For a sovereign debt litigation case to be seen under the FSIA, the bonds must be denominated in US Dollars. As stated in 28 U.S.C. § 1602,

> Under international law, states are not immune from the jurisdiction of foreign courts insofar as their commercial activities are concerned, and their commercial property may be levied upon for the satisfaction of judgments rendered against them in connection with their commercial activities. Claims of foreign states to immunity should henceforth be decided by courts of the United States and of the States in conformity with the principles set forth in this chapter.

Moreover, the FSIA does not make a distinction between the "state" and its "government". This

[10] The United States was the first country to codify sovereign immunity into a statute via the FSIA.

[11] Creditors could pressure their home governments—usually through lobbying—to put in place trade sanctions or intervene militarily. This primarily occurred in the 19th and 20th centuries. See Waibel (2011) for an explanation on how and when creditors requested their home government to intervene. Also, see Tomz (2007) and Mitchener and Weidenmier (2010) for a discussion on the uses of gunboat diplomacy in relation to sovereign debt repayment.

[12] As bonds are issued under New York Law it is the First Circuit Southern District of New York that hears these cases.

means that a current government can be held accountable for the debt taken on by previous governments even if there was a transition from autocracy to democracy. Additionally, a suit against a state-owned or operated entity—such as an oil company or central bank—is considered the "state" in suits. Given that the FSIA has a broad definition of the "state," sovereign debt litigation cases should be straightforward. A country defaults and is then taken to court by bondholders and is seen by a judge. The judge must either rule in favor of the plaintiff (against the defendant), rule in favor of the defendant (against the plaintiff), or dismiss the case (rule in no ones favor). However, sovereign debt litigation cases are not murder mysteries. There is no question over whether a country stopped payments and it is easy to confirm that the bondholders are indeed bondholders. In fact, governments have never attempted to dispute the occurrence of a default.[13] For this reason, states (defendants) should be losing all cases.

Shortly after its enactment, the first sovereign debt litigation cases arrived from the 1980s Latin American debt crisis. One case that came out of this crisis was CIBC vs. Banco Central do Brasil, which was brought to the court in 1995. This was the first case brought by a vulture fund.[14] CIBC had purchased $1.4 billion Brazilian bonds denominated in US dollars on the secondary market. Instead of participating in the restructurings, this hedge fund chose to take Brazil to court. Ultimately, Judge Barbara S. Jones chose to dismiss the case. A dismissed case is not necessarily a negative event for a country because it means that there is no court order to pay the creditor in the dispute, but if they wish to, that option is still available for the country. In the case of CIBC vs. Banco Central do Brasil, Brazil chose to settle with CIBC out-of-court despite the dismissal.

In a similar vein to that of the emergence of vulture funds, hedge funds have developed a new courtroom strategy beginning in the late 1990s. Hedge funds have attempted to utilize pari passu clauses that are often included in bond contracts to establish that all creditors will be treated equally in the event of a default. However, pari passu is often applied in corporate debt default cases because when corporations default there is often a liquidation and, therefore, the creditors involved want the goods divided in a manner they deem appropriate. As discussed, liquidation does not occur when a government defaults, which is why the application and interpretation of pari passu when applied to sovereign debt litigation has been highly contested.

The first sovereign debt litigation case to use pari passu is Elliot Associates vs. Republic of Peru in 1996. In this case, Elliot Associates argued that because of pari passu Peru cannot legally pay the

[13] They have tried to close suits by disputing (a) whether they are the originators of the debt, (b) whether they truly own the state operated oil company, or (c) by attempting to activate the Odious Debt Doctrine—a legal theory that a state should not be held accountable for debt taken on by an illegitimate or despotic regime—in their defense. See Gelpern (2005) for a discussion on attempts to implement the Odious Debt Doctrine.

[14] CIBC was a hedge fund that the Dart family was involved in. The Dart family owns the Dart Container Corporation, which is the largest producer of foam products such as cups and plates. They also own Dart Management, which is a vulture fund that has made a considerable profit from the financial crises in Argentina and Greece.

creditors they already settled with through restructuring negotiations. Judge Robert Sweet agreed with this interpretation of pari passu. In response to this court ruling, Peru chose to immediately settle with Elliot Associates—paid approximately $56 million—rather than default on all of their bonds. Although several other hedge funds after Elliot Associates have attempted to use pari passu, most were unsuccessful until the recent case of Argentina.

These case anecdotes highlight a puzzling occurrence—Plaintiffs do not always win. In CIBC vs. Banco Central do Brasil, it was clear that Brazil did default and that CIBC did own Brazilian bonds, yet the judge dismissed the case. After the strategic and successful use of pari passu by Elliot Associates in its case against Peru, the majority of those who came after using the same strategy failed. Despite the expectation for plaintiffs to win these straightforward cases, they are, in fact, not regularly winning.

The Argument and Hypotheses

What affects the decisions judges make? I argue that conservative judges are more likely to rule against the debtor state (the defendant) to enforce free market norms. The difference in ruling propensity between conservative and liberal judges is most acute when the defendant country has two characteristics—close economic ties with the US and a democratic form of government. Economic ties between the defendant and the US in the trade arena increases the probability that the plaintiff will win. This is due to the concern that a broken contract in one area of the economy will lead to broken contracts in other areas. Cole and Kehoe (1998) argue that the reputation of a government in the sovereign debt arena will affect other areas where interaction is dependent on trust. The potential for a negative spillover is particularly acute between the finance and trade arenas as trade is an area that is dependent on trust. In fact, Mansfield and Reinhardt (2008) have found that agreements can help reduce volatility in trade policy and trade flows. Hence, if a debtor state breaks their contract with creditors by defaulting, that government would be viewed as untrustworthy. This, in turn, would cause concern that the debtor state will then break contracts in the trade arena by implementing tariffs, non-tariff barriers, and expropriating.[15] Most simply put, a broken contract signals that a country has unstable economic policy.

The concern over a potential spillover from a broken contract in the sovereign debt arena into the trade arena should be more pronounced in countries where there is already existing trade competition. Trade competition here is defined as "…the extent to which two countries trade similar products with the same partners" (Kim, Liao, and Imai, 2020). Trade competition is not just about exports, but imports as well because with the growth of global supply chains, countries must also compete for inputs that

[15] Tomz and Wright (2008) examine the link between the different types of sovereign theft—debt default and expropriation—and conclude that more research needs to be done on how the honoring of contracts in one arena will lessen the occurrence of another form of theft.

permit them to produce the final product (e.g., raw materials, machinery parts, etc.). Due to the growth and characteristics of intra-industry trade, a country's greatest trade competitor is often the country that it also exports a significant amount to. For this reason, economic policy stability in these countries is important for the US. As similar products are being imported and exported, the importance of trade liberalization and policy stability has increased for the US government.[16]

To prevent spillover and send a signal that broken contracts will not be tolerated, I expect US judges to be more likely to rule in favor of the plaintiff in sovereign debt litigation cases where the US is in a trade competition with the defendant. This is because the US wants to ensure that the country it has economic ties with maintains a favorable investment climate. A ruling in favor of the plaintiff sends a signal to the defendant that a contract breach will not be ignored even in the adjacent sovereign debt arena.[17] The higher the trade competition is with the US, the more likely for the defendant to lose a sovereign debt litigation case because the impact of spillover in these countries would be more severe.

> H1: On average, the higher the trade competition with the United States, the more likely it is for a judge to rule in favor of the plaintiff.

However, while the amount of trade competition with the United States is one source that affects the decision-making of judges, it is not the only factor. The other factor that explains variation in outcome in sovereign debt litigation cases is the ideology of the judge. Judges are not mechanical decision-makers, but often decide cases on the basis of their personal preferences. For this reason, they can be seen as policymakers. Viewing judges as policymakers who are influenced by their ideology is not new or controversial. Studies have found judicial decision-making to be influenced by ideology (Segal and Spaeth, 2002; Sunstein et al., 2006; Epstein, Landes, and Posner, 2013). While ideology is not the sole factor that explains case outcomes (Sunstein et al., 2006), it can outweigh other factors (Martin et al., 2004). Ideology is important because US presidents are likely to nominate individuals that they believe are similar to themselves and, as such, vacant seats in the judiciary is an opportunity for a president to have a lasting effect on the judicial branch.

As presidents nominate judges that they believe have similar beliefs to their own, a left-right divide on sovereign debt is likely. Left-right divides have been found in advanced industrial countries on issues such as free-trade with left-wing parties advocating for more protectionist policies than right-wing par-

[16] In Song Kim (2017) finds that most political lobbying by firms for trade liberalization in the US is within industry.

[17] My theory argues the opposite from the theory put forth by Bulow and Rogoff (1989) who argue that in countries where US trade interests are most acute, court sanctions against a defaulting government does not occur, and, therefore, it is US citizens who would be footing the bill for a default rather than the defaulter. In my theory, that takes intra-industry instead of inter-industry trade into account, the debtor state must pay back its debt because it would hurt US investors.

ties (Milner and Judkins, 2004). In the United States, after 1970, Republicans increasingly became for free trade due to support from export-oriented business and agricultural interests and Democrats more protectionist as unions gained strength (Karol, 2000). In fact, most of the votes Clinton received for the passing of NAFTA in 1993 came from Republicans. Therefore, since finance and trade are inextricably linked, I expect there to be a left-right divide.

More specifically, I argue that conservative judges are more likely to rule against a defendant (in favor of the plaintiff) because of nationalistic and economic preferences. In addition to the concern over spillover into the trade arena, by ruling against a country, the conservative judge is sending a signal that bonds issued in US dollars have value for investors because they will get paid even in the event of a default. As many countries issue bonds in and fix their currency to the US dollar, the United States has an interest in the stability of the global financial market and in the financial stability of countries that its domestic constituents make investments in and trade with. This is why in the case of Allied Bank International vs. Costa Rica, the US government stated concern over maintaining the status of New York as the commercial capital of the world. With rulings in favor of the plaintiff, conservative judges are protecting the reputation of the US as a leader of the financial system and supporting economic openness as investors have confidence that their investments have some protection. In contrast, liberal judges are not as likely to rule in favor of the plaintiff[18] because they are less focused on the reputation of the United States as the financial center of the world. They do not have the same economic preferences.

H2: Conservative judges, on average, are more likely to rule in favor of the plaintiff.

Thus far, the primary motive to rule in favor of the plaintiff is to ensure that free market norms are upheld and to minimize the risk of spillover from the sovereign debt arena into the trade arena. However, there are institutional factors within the debtor state that also influence judicial outcomes. Democratic regimes have an advantage in sovereign debt litigation cases just as they have advantages when entering the sovereign bond market. The idea that democracies have an advantage in the sovereign debt arena began with North and Weingast (1989). They argued that due to the checks and balances, democracies are less likely to repudiate debt and, for this reason, sovereign bonds issued by democracies are desirable and come with lower interest rates. Since North and Weingast (1989), scholars have found that democracies have better access to the bond market and receive better bond ratings than comparable authoritarian regimes (Beaulieu, Cox, and Saiegh, 2012). Furthermore, Biglaiser and Staats (2012) find that the regime characteristics that influence credit ratings positively is the presence of strong courts, the rule of law, and

[18] They could rule in favor of the defendant or in a manner that maintains the status-quo (i.e., by dismissing a case.)

property rights.[19]

The institutional features of democracy work alongside the doctrine of international comity, which helps democracies gain an advantage in court. International comity[20] is a discretionary doctrine that permits a judge to dismiss a case out of respect for foreign sovereigns.[21] This means that the US will recognize acts, laws, and decisions made in another country. If international comity is applied to a sovereign debt litigation case, it is saying that the US judiciary respects the act of that particular debtor state to default. Comity is typically applied unless it violates "…some fundamental principal of justice, some prevalent conception of morals, [or] some deep-rooted tradition of the common weal."[22] In other words, comity should be applied in all cases except where it hurts the common good or public policy. However, there are no clear guidelines as to when international comity should be applied. Nevertheless, I expect cases are more likely to be dismissed when the defendant is a democracy.

A US judge will be more respectful and defer to the decisions of a democracy more so than an authoritarian regime. This is due to the presence of checks and balances and strong courts. The presence of multiple veto players should curb the ability of an executive to pass statutes (Tsebelis, 1995) that veer far from principles of justice. Utilizing international comity by dismissing a case when the defendant is a democracy occurs because the motives for default appear to be more legitimate than when it occurs within an authoritarian regime. A default damages both current and future financial opportunities, so there is likely to be veto players within a democracy that oppose it. Due to the nature of authoritarian regimes, the presence of checks and balances is difficult to discern. Furthermore, unlike with authoritarian regimes, courts in democracies are more likely to have a similar respect for the rule of law to that of the US, which lends credibility to the decision of a defendant that is a democracy to default. Hence, from the perspective of a judge, a default in a democracy will only occur when it absolutely must, which is why they are likely to dismiss the case and permit the default decision to remain a domestic issue. The more democratic a country is, the less likely it is for a judge to rule against them.

> H3: On average, the more democratic a country is, the less likely for a judge to rule in favor of the plaintiff.

However, the second characteristic that affects the extent to which conservative judges will rule against the debtor state to enforce free market norms is regime type. Democracies tend to attract the

[19] Also see Biglaiser and Staats (2010) for information on why firms are attracted to democracies with strong courts and adherence to rule of law.

[20] As defined by the Supreme Court, international comity is "the recognition which one nation allows within its territory to the legislative, executive, or judicial acts of another nation…" (*Hilton v. Guyot, 159 U.S. 113, 164*, 1895)

[21] See Estreicher and Lee (2020)

[22] *Fannie F. Loucks et al., as Administrators of the Estate of Everetta, 224 N.Y. 99* (1918)

most intra-industry trade (Madeira, 2014) due to their ability to enforce written contracts (Nunn, 2007).[23] Therefore, there is a group of countries that are in a trade competition relationship with the United States that are also democracies. My theory thus far has generated three hypotheses. First, the higher the trade competition between the United States and the defendant, the more likely for plaintiff to win. Second, conservative judges are more likely to rule in favor the plaintiff due to economic nationalistic concerns. Third, plaintiffs are more likely to lose a case when the defendant is a democracy. With this in mind, how do judges rule in cases where the defendant has a trade competition relationship with the United States and is a democracy? I argue that the propensity for liberal and conservative judges to rule in different directions is most acute with democracies as defendants. Although democracies have better property rights and rule of law, these factors do not mitigate the importance of free trade and stable economic policy for conservative judges. Unlike their liberal counterparts, conservative judges are more likely to rule against the defendant because they feel strongly about enforcing free market norms when the US has close economic ties with the defendant country. This is even the case when the defendant is a democracy. In contrast, liberal judges are more likely to defer to the decisions of a democracy to default and keep the default choice a domestic issue.

> H3b: Conservative judges are more likely to rule against a defendant that is a democracy than liberal judges.

A New Data Set on Judicial Decision-Making

To assess the history of sovereign debt litigation since the enactment of the FSIA in 1976, I have constructed a new data set that covers the period from FSIA inception to July 2019. Sovereign debt litigation cases are taken to court in New York State because US bonds are issued under New York law. The first case to reach the United States District Court for the Southern District of New York (SDNY) was in 1982, so the data set begins that year. This data set was acquired by performing a web-scrape of the Public Access to Court Electronic Records (PACER) website. A sovereign debt litigation case, for this data set, is defined as any case where financial assets were issued through the central bank.

As there is no PACER search function that allows one to limit a search to sovereign debt litigation cases, using RSelenium, I supplied a broad list of state-owned entities and country names to the website to enable a thorough search, which then downloaded all court cases in HTML format from the SDNY.[24] After saving all court dockets that are produced from this search, I then remove all cases that are not

[23] See Nunn (2007) for an explanation of why contract enforcement is a comparative advantage in trade relationships.
[24] See Appendix 1A for list of countries and state-owned entities included in the search.

sovereign debt litigation cases. Once the sample only included sovereign debt litigation cases, I then scraped the saved HTML documents for items such as the Docket Number, case name, the plaintiffs involved, the judge assigned, amount of money demanded by the plaintiffs, amount of money awarded by the judge, start and end date of a case, the nature of the case, and the Judge's decision. I added information about who nominated each judge and their party affiliation after the scrape.

The resulting data set is at the docket[25] unit level. This means that there are multiple observations per country-year for some countries. I identify 353 sovereign debt litigation cases brought to the SDNY. This is the most comprehensive and up-to-date data set on this issue. In fact, 25 cases in this data set are still ongoing. Table 1 provides an overview of the data on judges in the data set and Table 2 provides an overview of the case and plaintiff information.

Table 1: The Data By Judicial Characteristics Briefly Presented

Docket Number	Country	Start Year	Judge	Party	President
1:84-cv-08101-JSM	Nigeria	1984	John S. Martin	Republican	George H.W. Bush
1:86-cv-09935-MJL	Bolivia	1986	Mary Johnson Lowe	Democrat	Jimmy Carter
1:90-cv-06639-DNE	Liberia	1990	David N. Edelstein	Democrat	Harry Truman
1:90-cv-03972-RJS	Uganda	1990	Charles S. Haight	Republican	Gerald Ford
1:90-cv-03651-RPP	Peru	1990	Robert P. Patterson	Republican	Herbert Hoover
1:94-cv-04733-BSJ	Brazil	1994	Barbara S. Jones	Democrat	Bill Clinton
1:96-cv-06360-JFK-RLE	Nicaragua	1996	John F. Keenan	Republican	Ronald Reagan
1:96-cv-06586-MGC	Iraq	1996	Miriam Goldman Cedarbaum	Republican	Ronald Reagan
7:06-cv-05969-SCR	Liberia	2006	Charles L. Brieant	Republican	Richard Nixon
1:14-cv-09844-KBF	Ecuador	2014	Katherine B. Forrest	Democrat	Barack Obama
1:15-cv-00725-RJS	Ecuador	2015	Richard J. Sullivan	Republican	George W. Bush
1:08-cv-00164-LAP	Argentina	2008	Thomas P. Griesa	Republican	Richard Nixon
1:15-cv-05551-DAB	Peru	2015	Deborah A. Batts	Democrat	Bill Clinton
1:14-cv-08242-LAP	Argentina	2014	Loretta A. Preska	Republican	George H.W. Bush

[25] A docket number is the number assigned to each individual case in US courts.

Table 2: The Data By Plaintiff Characteristics Briefly Presented

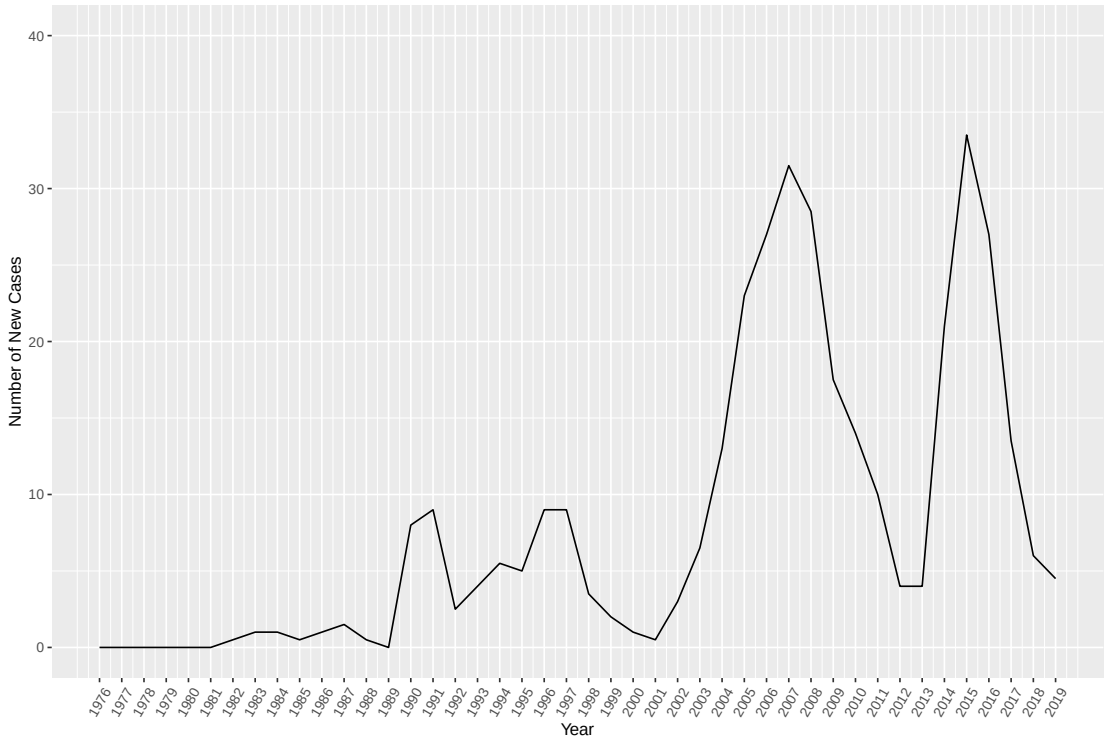
Docket Number	Country	End Year	Plaintiff	Plaintiff Type	Amount Awarded
1:91-cv-06500-LBS	Iraq	1992	The Commercial Bank of Kuwait	Bank	44033473.93
1:96-cv-07034-SS	Zambia	1997	Camdex International, Ltd.	Hedge Fund	0
1:96-cv-05849-KMW	Iraq	1998	Commodity Credit Corporation	Hedge Fund	6034642139
1:02-cv-01246-JSM	Liberia	2002	FH International Financial Services, Inc.; SIFIDA Investment Company, S.A.; Wall Capital, Ltd.; Hamsah Investments, Ltd.	Hedge Fund	18371736.36
1:06-cv-03976-LAP	Argentina	2007	Andres Jacinto Alzugaray; Maria Cristina Aste	Individual	5967940.49
1:15-cv-00725-RJS	Ecuador	2016	Daniel Penades	Individual	0
1:15-cv-09630-KPF	Central African Republic	2017	The Export-Import Bank of The Republic of China	Bank	362279402.8

As with any sanctioning device, there is a question about how often it is used. Figure 1 plots the number of new cases brought to court since 1976 to 2019. Of course, how much US courts are used for sovereign debt litigation is driven by the number of defaults per year and the size of a default.[26] Hence, there are peaks and valleys in the number of *new* cases brought each year. Nevertheless, as presented in Figure 1 below, it appears that US courts are being used in an attempt to sanction debtor states.

After bringing a suit to court, whether and the extent to which a country is sanctioned is dependent on the ruling by the judge appointed to the case. District court judges are initially randomly assigned to a case. Currently, the SDNY has forty judges, which means that if a new case were brought to the court today, random selection would occur among these forty individual judges. However, some cases are not randomly assigned if there is a similar ongoing case. For example, Judge Griesa was initially randomly assigned to an Argentine sovereign debt litigation case in 2002. As more Argentine cases were brought forward, they were all assigned to Judge Griesa until his death in 2017. Hence, in the data set, Griesa is listed as the deciding judge in all cases brought against Argentina in the 2002-2017 period.

[26] See Schumacher, Trebesch, and Enderlein (2018) for an examination of the factors that drive creditors to court.

Figure 1: New Case Initiation by Year



How many judges have been involved in past sovereign debt litigation cases? Table 3 below presents the number of unique judges involved in sovereign debt litigation by President. There are a total of 55 different judges nominated by 10 US Presidents that were involved in the 353 cases present in the data set. As can be expected, there are very few judges nominated from the Gerald Ford (1974-77), Harry Truman (1945-53), and Herbert Hoover (1929-33) presidencies in the data set because of factors such as (a) when the president held office and (b) the number of judicial vacancies during a president's term. For instance, 52 district court judges were nominated and appointed during the Ford presidency which is much lower than the 305 district court judges nominated and appointed during the Clinton presidency. Moreover, in addition to presidential opportunity to nominate a judge, when a president held office can contribute to the number of overall judges by president involved in sovereign debt litigation cases. Many of the judges nominated by President Hoover or Truman would either have retired or passed away by the time the first cases under the FSIA would have made it to the court.

With sovereign debt litigation cases, there are multiple ways in which a case may be closed. The primary division is between cases decided by a judge and those closed by other actors. There are three ways in which a judge can close a case: (1) they can rule in favor of the Plaintiff, (2) they can rule in favor of the Defendant, or (3) they may dismiss the case without having to rule in anyone's favor. Outside of a judge's control, there are four other methods of case closure: (a) The US put a freeze on all cases that

Table 3: Number of Judges involved in Sovereign Debt Litigation by President

President	Number of Judges
Barack Obama	10
Bill Clinton	19
George H.W. Bush	3
George W. Bush	5
Gerald Ford	1
Harry Truman	1
Herbert Hoover	1
Jimmy Carter	3
Richard Nixon	6
Ronald Reagan	6

Note: Judges are initially randomly selected into overseeing a case.

involve assets of a country,[27] (b) the case is closed administratively Pursuant to Memorandum From the Administrative Office of the United States Courts,[28] (c) the case closed before reaching a judge, and (d) out-of-court settlement. Out-of-court settlement is the the most common reason for case closure outside of a judge's purview. A case is coded as being closed due to an out-of-court settlement when the court document states that there is an "order of dismissal on consent" or that it was dismissed Pursuant to Rule 41(a). For example, in Greylock Global Distressed Debt Master Fund Ltd. et al v. The Republic of Argentina where the outcome was a voluntary out-of-court settlement, the document states the following:

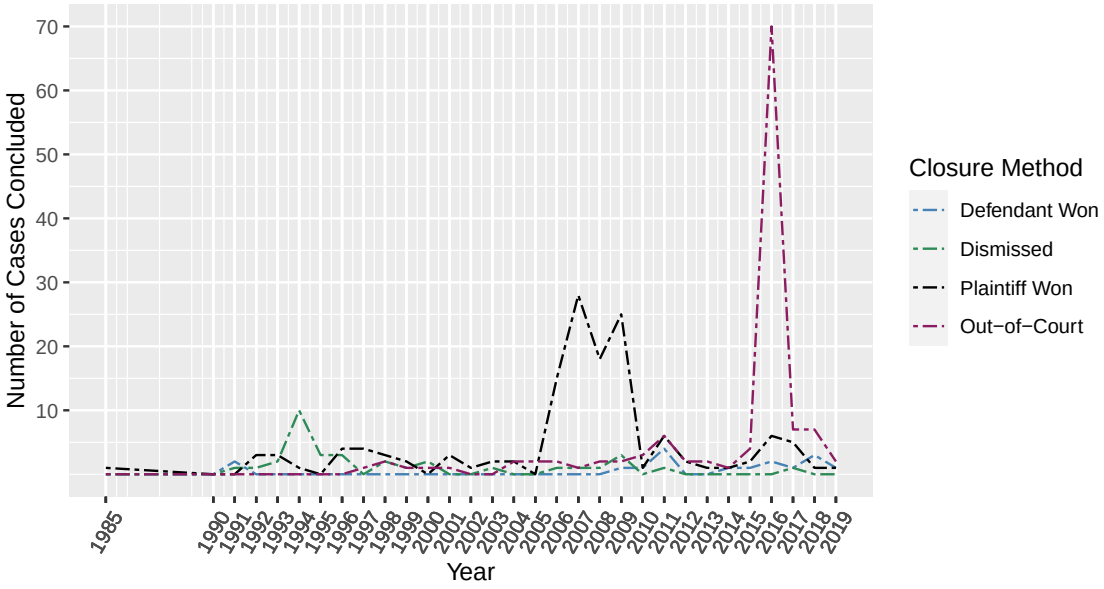
> STIPULATION AND ORDER OF DISMISSAL: Pursuant to Rule 41(a) of the Federal Rules of Civil Procedure, Plaintiffs Greylock Global Distressed Debt Master Fund, Ltd. and Greylock Global Opportunity Master Fund, Ltd. (together, "Plaintiffs") and Defendant The Republic of Argentina, by and through their respective undersigned counsel of record, hereby stipulate that all claims of the Plaintiffs in this proceeding are hereby dismissed with prejudice, with each party to bear its own attorneys' fees and costs. The Republic of Argentina terminated. (Signed by Judge Thomas P. Griesa on 12/5/2016)

How are most cases concluded? Figure 2 below presents the number of cases closed by method and year. Only the most common closure methods are presented, which are the three options available to a judge and out-of-court settlement. The other case closure methods occur irregularly and rarely, so they

[27] This happened with Iraq for a very brief time period.
[28] This effectively means putting a case on hold.

are not represented in the graph below. In Figure 2, there are two large peaks in the data. The first peak is that of plaintiffs winning cases brought against Argentina under Judge Griesa. The second peak occurs in 2016 after Mauricio Macri—who ran on a platform that prioritized ending the legal saga with creditors—was elected President of Argentina. Once Macri was elected, creditors settled out-of-court as the Argentine government was now more willing to negotiate. Excluding these two peaks, there does not appear to be any case closure option that occurs more regularly than all others.

Figure 2: Total number of Closed Cases by Year and Method



Data and Empirical Analysis

To answer the question of what affects the decisions judges make, I use two empirical tests. For the first test, I use probit Bayesian hierarchical modeling to attain an overall picture of what influences sovereign debt litigation outcomes. The second test applies Virtual Twins, which is a method that first creates a counterfactual where the judge is a liberal rather than a conservative (or vice versa) and then identifies a subgroup of observations where being assigned to a conservative judge has an impact. Nevertheless, the primary problem with analyzing sovereign debt litigation is self-selection into the arbitration process. That is, plaintiffs are likely to bring a case to court if they believe they can win and make a profit. This is why there has been an increase in vulture funds. Although I am interested in what happens after the selection process, the selection process itself may influence outcomes. If plaintiffs are only bringing cases that they believe they can win, then, in conjunction with the expectation that most cases should be won by plaintiffs because the facts are difficult to dispute, plaintiffs should not be losing any case. In other words, this self-selection is biased against the theory that variation exists in the outcome due to

various economic and political factors. Nevertheless, despite this self-selection into arbitration and the indisputable facts of a sovereign default, the data suggest that plaintiffs do not always win. Therefore, this implies that politics has a role to play in sovereign debt litigation cases.

Variables

Sovereign debt litigation involves the choices and decisions of three actors: the Judge, the Plaintiff, and the Defendant. From the information attained from the web-scrape, I create variables for each actor that are used in conjunction with variables from other sources. For the judge level variables, I include an indicator variable for the gender of a judge— JUDGE GENDER—with female coded as "1" and male "0".[29] As a proxy for the ideology of judge, I use the partisan affiliation of the president who nominated them with Republicans considered as conservative and Democrats as liberals. APPOINTMENT is a binary variable that takes on a value of "1" if the judge was nominated by a Republican and "0" if by a Democrat.

Next, for the plaintiff level variables, I create a binary variable indicating whether there was an attachment attempt or not. When a judge puts an attachment order on a country, it means that the creditor in that case can legally seize the defendant's property to recoup their losses from the default. I code attachment requests rather than attachments awarded by a judge because a plaintiff that requests an attachment may be more aggressive than one that did not. If a plaintiff requests an attachment, ATTACHMENT ATTEMPT is coded as "1" and "0" otherwise. Another plaintiff level variable from the scrape is a binary variable for whether a plaintiff is a hedge fund.[30] HEDGE FUND takes on the value of "1" if plaintiff is a hedge fund and "0" otherwise. Hedge funds are known for using tactics to win suits that other plaintiffs are not known for implementing, which may influence outcomes.

For the defendant level variables, I include REGIME TYPE from the Varieties of Democracy (V-dem) data set. In the main analysis I use the liberal democracy index from V-dem because this measure focuses on the strength of the rule of law, the independence of the judiciary, and the constraints on the executive (Coppedge et al., 2020).[31] The liberal democracy index is constructed such that the values range from 0 to 1 with 1 being the most democratic. Additionally, IMF PROGRAM is included as an indicator of the general economic climate in the country and is coded as "1" if the defendant was participating in an IMF program the year before or during a case and "0" otherwise. Also included is ONGOING SANCTIONS that is coded as "1" for any time the defendant was under US sanctions and in court and

[29] See Smith (2005) for an analysis of how the gender of a judge may affect outcomes.

[30] In the raw data set, plaintiffs come in many forms which include individuals, banks, hedge funds, mixed coalition (For some cases, individuals, banks, and hedge funds, may jointly bring a suit.), and a city. Note that there is only one city (City of New Rochelle in New York) that has brought a case against a country (Liberia).

[31] As a robustness check, the electoral democracy index (polyarchy) from V-Dem is used in lieu of the liberal democracy index.

"0" otherwise. Ongoing sanctions is included because sanctions are a foreign policy tool and the use of sanctions suggests that the current administration may have negative relations with the defendant that may influence judicial outcomes.

In addition to the above defendant level variables I include INVESTMENT PROFILE, which is a variable from the ICRG data set that covers the years from 1984 to 2014. The measure is based on a survey of investors about how concerned they are about the risk for contract viability/expropriation, profits repatriation, and payment delays. Values range from 0 to 12 with 12 being low risk and 0 high risk. This variable needs to be included because the investment policies of individual countries may a) increase or decrease the amount invested in a country and b) determine the behavior of defendants during a trial. This variable is lagged by a year in the Bayesian Hierarchical Model.

The key variable of interest at the defendant level is TRADE COMPETITION. This measure was attained from Kim, Liao, and Imai (2020) who use a dynamic clustering method to measure the degree of competition between two countries. Kim, Liao, and Imai (2020) provide measures of trade competition from a 3, 7, and 15-cluster model. The more clusters there are, the more refined the data is.[32] Due to my theory, I chose to use the data resulting from the 15-cluster model because it is most representative of intra-industry trade. Trade competition is a proxy for US economic interests towards the defendant country. Of course, this measure does not reveal whether the executive branch is representing a coalition of interests that may or may not include investors that engage in intra-industry trade with that particular defendant or simply an agent of a particular set of actors. This is simply a measure of economic relations between the United States and the defendant country.

As I am interested in the outcomes of these cases, my dependent variable—PLAINTIFF WIN—is a binary measure that takes on a value of "1" if the Plaintiff won and "0" otherwise. This dependent variable is appropriate for several reasons. First, as discussed, a case that was dismissed by a judge is a positive outcome for the defendant because they are not *legally* responsible for paying creditors back. Case dismissal rarely occurs due to lack of evidence or questions relating to the legitimacy of the case. International comity is extended due to judicial preferences. Second, out-of-court settlements occur once the debtor is willing to negotiate.[33]

[32] For example, with a 15-cluster model the data would be clustered by whether it is a fuji or gala apple, but with fewer clusters trade competition is between apples and bananas.

[33] A debtor state could become willing to negotiate either because of a change in government and/or repetitive losses. For example, out-of-court settlements in the Argentine case occurred after Judge Griesa made multiple decisions against Argentina and a new Argentine president who was less hostile towards the idea of settling with creditors was elected.

Bayesian Hierarchical Model: Evaluating the Landscape

The nature of the data—repeated measures from the same country, president, and judge—lends itself to hierarchical modeling. For this analysis, I use a probit hierarchical model with country, president, and judge random effects.The priors used in this analysis are vague.[34] In addition to using Bayesian hierarchical modeling, I also manage the missing data by imputing the data using MCMC. There is missing data because the sovereign debt litigation data is available until 2019, but the independent variables from other sources in this analysis, such as TRADE COMPETITION and INVESTMENT PROFILE, are unavailable through 2019. For this reason, I consider the missingness in this situation as Missing Completely At Random. For continuous missing data, I draw from the normal distribution and for binary variables the Bernoulli distribution.

The table below presents the results, which, in addition to the mean and SD, includes the lower and upper bound of the 95% credible interval.[35] Furthermore, the Monte Carlo standard error of the mean (MCerr) is included and is an indicator of how much error is in the estimate from using the MCMC method. The closer the MCerr is to zero the better and this typically occurs as number of iterations in the analysis increases. Relatedly, the Monte Carlo standard error as a percent of the SD (MC%ofSD) is also provided and ideally the MC error will be smaller than the posterior standard deviation, so a rule of thumb is 5% or less. Also included is the the potential scale-reduction factor of the Gelman-Rubin statistic (psrf) also known as the R-hat. The Gelman-Rubin statistic examines whether the between variance and within chain variances are equal. The rule of thumb is that everything below 1.1 is acceptable and the closer to 1 the value is the better. Larger values means that there is a large difference between the chains. Lastly, I include Bayesian p-value's (P>0), which is a test of the direction of the effect.

The main variables of interest are TRADE COMPETITION, APPOINTMENT, and REGIME TYPE. From my theory, I expect TRADE COMPETITION to be in the positive direction, APPOINTMENT to be in the positive direction, and REGIME TYPE to be in the negative direction. The results from a probit hierarchical model with country, president, and judge random effects are presented in Table 4.[36]

[34] Specifically, I used (.01, .01) for the precision and (0, .01) for the mean. This allows the model to rely on the data for estimation.
[35] Calculated using the highest posterior density interval.
[36] Results with just country and president random effects and different measures of democracy are included in Appendix 1C.

Table 4: Bayesian Hierarchical Model

	Mean	SD	Lower95	Upper95	P>0	MCerr	MC%ofSD	psrf
Intercept	-1.89518	1.53341	-4.92960	1.04416	0.10358	0.03424	2.2	1.00123
Trade Competition	0.07530	0.04209	-0.00453	0.15931	0.97126	0.00028	0.7	1.00009
Appointment	0.12440	1.48191	-2.85708	3.05555	0.53152	0.03063	2.1	1.00077
Regime Type	-0.57142	1.92965	-4.29527	3.30033	0.37140	0.02989	1.5	1.00107
Ongoing Sanctions	0.82259	0.59031	-0.23574	2.02048	0.94240	0.00527	0.9	1.00038
Hedge Fund	-0.89544	0.20216	-1.29115	-0.50050	0.00000	0.00095	0.5	1.00000
Attachment Attempt	2.00278	0.35185	1.32798	2.69923	1.00000	0.00169	0.5	1.00002
IMF Program	1.58845	0.93199	-0.17092	3.42600	0.96698	0.00713	0.8	1.00004
Investment Profile	0.06185	0.12777	-0.18545	0.31831	0.68892	0.00146	1.1	1.00040
Judge Gender	-1.04121	0.87261	-2.80344	0.63629	0.11066	0.00527	0.6	0.99999

The mean of the TRADE COMPETITION variable is in the positive direction and the probability that it is in the positive direction is .97, which supports Hypothesis 1. The higher the trade competition is with the United States, the more likely it is for the defendant to lose the case. The APPOINTMENT variable is in the positive direction and the probability that it is in the positive direction is .53. While this does not support Hypothesis 2, it is still possible that the division between conservative and liberal judges is more pronounced for some groups of countries. The REGIME TYPE variable is in the negative direction and has a .37 probability of being in the positive direction. This means that the plaintiff is less likely to win as the level of democracy increases in the defendant country, which supports Hypothesis 3. The MCerr is near zero for all of the independent variables and the MC%ofSD is below 5% for them all as well. For all variables, the Gelman-Rubin statistic (psrf) is near 1.The statistical results for the country, president, and judge random effects are presented Appendix 1B along with convergence diagnostics.

Overall, the results from this model lend support to Hypothesis 1 and 3. However, there are limitations to using Bayesian hierarchical modeling. Due to the size of the data set, it is unfeasible to include interactions and, therefore, test Hypothesis 3b. In a setting where the N was larger, using the classical approach of including interactions between the treatment—APPOINTMENT—and the covariates would be acceptable. As a model with interactions cannot be implemented here, I use a method that identifies subgroups[37] to examine whether there would be a difference in outcome if a case was assigned to a judge with a different ideological leaning.

[37] It should be noted that subgroup identification and interactions are not perfect substitutes for each other.

Virtual Twins

Virtual Twins (VT)[38] combines machine learning and causal inference by utilizing Random Forests (RF) and Regression Trees. The main purpose of this method is to identify subgroups that have an enhanced treatment effect. In other words, some subgroups may benefit (or be harmed) more from a treatment than other groups. It is particularly useful in cases where the overall treatment effect is small or insignificant, but there may be a subgroup where the treatment is particularly harmful or beneficial. The VT method uses the same concepts from counter-factual models and can be easily applied to studies that have a binary or continuous dependent variable.

The first step in implementing VT is to utilize RF, which is a method that outputs average predictions. Under VT with a binary dependent variable, for each observation, there are two potential outcomes with only one of these outcomes observed in the data. VT implements a random forest to predict the probability of an outcome occurring for each individual observation and, therefore, creates a counter-factual. This is done by first by utilizing RF to regress Y_i on the pre-treatment covariates of interest (X_i) and the observed treatment (T_i) and then re-estimating RF where the treatment is changed to $1 - T_i$. Hence, for each observation, VT outputs two predicted probabilities—the treatment ($\hat{P}_{1i}$) and control "twins" ($\hat{P}_{0i}$)—that each individual observation will have an outcome of "1". To obtain the individual treatment effects, the difference between the treatment and control "twins" is taken for each observation i. This is defined as $Z_i = \hat{P}_{1i} - \hat{P}_{0i}$.

After Z_i is obtained, the second step is to create a regression tree with Z.[39] With a regression tree, the data is split based on the independent variable that reduces the heterogeneity in the dependent variable—here being Z—the most. In this manner, the most important independent variables are selected. The goal is to obtain covariates that are strongly correlated with Z, which are then used to define a region A that contains the observations where the treatment effect is greater than the average effect for the whole sample. When applying the regression tree, Z becomes the dependent variable and covariates X.[40] From the regression tree, values of Z_i is predicted for each observation. Then, using a pre-defined threshold c, the predicted values of Z_i are used to define a region $\hat{A}$. The observations that are greater than c are included in $\hat{A}$. The formula below is used to obtain a measure of the enhanced treatment effect in the subgroup region $\hat{A}$. It is important to note that $\hat{Q}\hat{A}$ is the difference between the estimated treatment effect within the subgroup and the estimated overall treatment effect.

[38] For more information on VT, see Forest, Taylor, and Ruberg (2011)

[39] A classification tree could also be used.

[40] With the Classification Tree a binary variable from Z must be created. Any value greater than threshold c is coded as "1" and "0" otherwise.

$$Q(A) = (P(Y = 1|T = 1, X\epsilon A) - P(Y = 1|T = 0, X\epsilon A)) - (P(Y = 1|T = 1) - P(Y = 1|T = 0))$$

In this analysis, I define threshold c as $\delta + 0.1$ where δ is the overall mean treatment effect. Subgroups that have an enhanced treatment effect are those that are 10% greater than the overall mean. To obtain an estimate of $\hat{Q}(\hat{A})$, I use the re-substitution method (RM) and the simulate new data (SND) approach. With RM, $P(Y = 1|T = 1\ , X\epsilon\hat{A})$, $P(Y = 1|T = 0\ , X\epsilon\hat{A})$, $P(Y = 1|T = 1)$, and $P(Y = 1|T = 0)$ are estimated from the data and substituted into the equation for $Q(A)$. RM is likely to suffer from bias and over-fitting. To mitigate this, I also use SND, which is a parametric bootstrap approach. The SND will lead to less bias and over-fitting of the model.

When applying VT to this substantive issue, I continue to use PLAINTIFF WIN as the dependent variable. For the pre-treatment variables, the same independent variables as before are used except for JUDGE GENDER as this is not a pre-treatment variable[41] and INVESTMENT PROFILE is not lagged in this analysis. Furthermore, with VT, it is not possible to use random effects, so I also include ARGENTINA, which is a binary variable that takes on a value of "1" if Argentina was the defendant. This is necessary because Argentina's 2001 default was the largest in history and, for this reason, it received an unprecedented amount of suits brought against it. To ensure that the results are not being driven by Argentina, this indicator variable is included.

I use APPOINTMENT as the treatment. This means that a conservative judge presiding over a case is the treatment. US judges are initially randomly selected to preside over a case. However, when there are repeated cases brought against the same plaintiff, often, but not always, the same judge will be assigned to all of the cases (Macfarlane, 2014). Judge assignment may be quasi-random. This is not only the case with sovereign debt litigation, but with all issue areas. It is not, however, a guarantee that the same judge will preside over cases brought against the same plaintiff. A potential plaintiff cannot be certain that they will receive the same judge as a plaintiff who just won a case against the same defendant.

For this analysis, I dealt with the missing data by using Multivariate Imputation by Chained Equations[42] and created 20 imputed data sets. VT with 1000 bootstraps was applied to each data set and the results for $\hat{Q}\hat{A}$ and the overall treatment effect are pooled.[43] The complexity parameter (CP) for the regression trees are set to .10. This number was chosen after allowing the trees to fully grow and then choosing a CP where the 10-fold cross-validated error flattens out, which is the smallest tree size that is

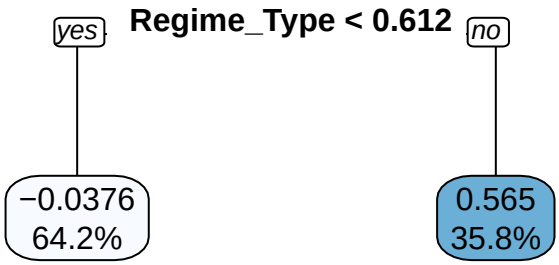
[41] All judge level variables are not pre-treatment.
[42] I used the MICE package in R.
[43] There are currently no methods to pool 20 regression trees from multiplied imputed data sets to display a single tree, so one is presented below and the remainder are in Appendix 1D.

within one standard error of the minimum.[44] The treatment effects and regression tree are presented in Table 5 and Figure 3 below, respectively.[45]

Table 5: Virtual Twins Results

	Estimate	SE	Lower CI	Upper CI	P-Value
RM Subgroup	0.7019	0.0000	0.7019	0.7019	0.0000
SND Subgroup	0.5857	0.0223	0.5420	0.6294	0.0000
Overall	0.1044	0.0869	-0.0658	0.2747	0.2293

Figure 3: Regression Tree Results from Virtual Twins



To detect heterogeneous treatment effects, a regression tree selects independent variables that cause the greatest decrease in heterogeneity in the dependent variable. The data here are split into subgroups by the REGIME TYPE variable.[46] REGIME TYPE is the variable that explains the outcome in sovereign debt litigation the most according to this model as it is the root node. This does not mean that the other variables are irrelevant. The infliction point is at .612. For context, within this sample, REGIME TYPE has a minimum of .0290, a mean of .5041, and a maximum of .8190. The split is between countries that have some form of checks and balances, an independent judiciary, and the presence of the rule of law, and those that do not.

In the regression tree, the rectangles present the final subgroups and in each rectangle the percentage of the sample size of the corresponding subgroup and the mean estimated individual differential treatment effect are included. The individual differential treatment effect is not $\hat{Q}(\hat{A})$. $\hat{Q}(\hat{A})$ is the overall subgroup differential treatment effect, which is presented in Table 5. The subgroup that $\hat{Q}(\hat{A})$ estimates is the one that is the farthest to the right.

[44] Also, when using multiple imputation with VT, it is best to be conservative and not let the tree grow out too much. Saying less is more in this case.
[45] Appendix 1E presents the VT results with the Polyarchy measure used in lieu of the Liberal democracy measure.
[46] The regression trees in the appendix are nearly identical to this one and identifies the same subgroup.

Although VT is a method to detect heterogeneous treatment effects, the results can be used to evaluate the strength of Hypothesis 2. Similarly to the results from the Bayesian hierarchical model, the difference between conservative and liberal judges, across the whole sample, is small and insignificant in the VT model. The overall treatment effect is .10 and the p-value is .22. Despite the lack of support for Hypothesis 2, Hypothesis 3b is supported by this model.[47] There is a subgroup that is more greatly affected by being assigned a conservative judge. The RM subgroup estimate is .70 and it is statistically significant at the .0001 level. The SND subgroup estimate is .59 and it is statistically significant at the .0001 level. These results suggests that for a subgroup of defendants, conservative judges are more likely to rule in favor of a plaintiff than a liberal judge.

The regression tree visually confirms that the lack of support for Hypothesis 2 and support for Hypothesis 3b. For Hypothesis 3b, in the terminal node defined by REGIME TYPE < .612, on the right-hand side, the difference in probabilities of the treatment and control "twins" is 0.565, which accounts for 35.8% of the whole study population. This is the terminal node that $\hat{Q}(\hat{A})$ estimates. The subgroup that is most affected by being assigned to a conservative judge are those who have a value of REGIME TYPE above .612. However, there does not appear to be a discernible difference between conservative and liberal judges across the entire sample. Evidence to support Hypothesis 2 with this model is lacking. In the terminal node defined by REGIME TYPE < .612 on the left-hand side, the difference in probabilities of the treatment and control "twins" is -0.0376, which accounts for 64.2% of the whole study population. On the right side, there is a difference, but it is among 35.8% of the population. Conservative judges are not more likely to rule in favor of the plaintiff across the whole sample.

Discussion

Despite the expectation for plaintiffs to win regularly, they do not. What affects the decisions judges make? I argued that ideological inclinations affect judicial decision-making and that it is conservative judges that are most likely to rule against the debtor state because they want to enforce free market norms. The general concern is that if a country violates a debt contract, there is a chance that they will breach contracts in other economic arenas as well. The potential threat of spillover is must acute where there is already existing trade relations between the US and the defendant. To assess the relationship between economic ties and litigation outcome, the first hypothesis examined whether higher levels of trade competition with the United States, increased the probability for a judge to rule in favor of the plaintiff. The results from Table 4 and those in the appendix, all suggest that as TRADE COMPETITION increases, the probability of the plaintiff winning a case also increases. While this finding does not

[47] Hypotheses 1 and 3 are not tested in this analysis.

address the ideological inclinations of judges in decision-making, it establishes that there is a link between sovereign debt and the adjacent trade arena.

In addition to the general relationship between economic ties with the US and a negative outcome for the defendant, I expected conservative judges to be more likely to rule in favor of the plaintiff. As a left-right divide exists over free trade, this propensity to favor different economic policy may have transferred over to the sovereign debt arena. However, the analysis suggests that there is no systematic difference between conservative and liberal judges across the whole sample. This was confirmed with the Bayesian hierarchical model and the VT model. Although there was a correlation between economic ties via trade competition and litigation outcomes, there is no correlation between APPOINTMENT and outcomes despite a left-right divide over trade policy. Judicial ideological inclinations cannot by itself predict litigation outcomes. While there is no left-right divide over the entire population, this result does not exclude the possibility of a left-right divide within a subgroup.

Along with economic ties, the regime type of the defendant if a factor in judicial decision-making. Defaults are ultimately a decision by domestic actors and it is a costly one. Theoretically, the more veto players there are, the less likely it is for default to occur unless it is absolutely needed as there is likely a group of actors who are against defaulting. In conjunction with the number of veto players in a regime, the presence of a court that has a similar respect for the rule of law to that of the US lends legitimacy to the decision to default. Defendants who respect the rule of law, have multiple veto players, and a court are typically democracies. For this reason, I expected a judge to utilize international comity and dismiss the case (not rule in favor of the plaintiff) if the defendant is a democracy. In the Bayesian hierarchical model, it was found that as the level of democracy increases, it became less likely for plaintiffs to win.

Of course, there is a relationship between regime type and trade. Democracies attract more intra-industry trade because it is investors who utilize global supply chains that are most reliant on the ability of the host country to enforce written contracts. Hence, I argued that conservative judges will rule against the defendant more often than a liberal judge when a country is a democracy. This is because conservatives are concerned about the promotion of free trade and in protecting US interests more so than the liberal judges and it is democracies that are most involved in intra-industry trade. Ideological inclinations should be more pronounced when the defendant is a highly democratic country as conservative judges are likely to rule against them and liberal judges in the defendants favor as they are likely to extend international comity to democracies. To test for this heterogeneous treatment effect, I used VT and found that the greatest difference between conservative and liberal judges occurs among defendants who are democracies. Overall, impartiality in the judiciary does exist, but differences along ideological lines are most visible when the defendant is a democracy due to their involvement in international trade.

Conclusion

In 1976, the United States enacted the Foreign Sovereign Immunities Act, which permitted domestic and foreign nationals to sue a foreign entity in US courts. Since this enactment, hedge funds have increasingly gone to the SDNY to bring cases against countries that have defaulted. These lawsuits can have a debilitating effect on the defendant country by wrecking havoc on the domestic economy through shrinking employment opportunities and price increases in necessities like food. For this reason, the goal of this paper was to understand who wins and who loses sovereign debt litigation cases. What affects the decisions judges make? At face value, the answer is obvious. Plaintiffs should be regularly winning cases because the evidence is clear—it is not possible to deny the occurrence of a default—and plaintiffs are likely to bring cases that they believe will win in court. However, this is not what occurs in practice. Plaintiffs do not win every case brought to the SDNY.

I demonstrate that the ideological inclinations of judges can explain case outcomes. These ideological inclinations work in conjunction with the characteristics of the defendant. Defendants that have close economic ties with the United States are more likely to be ruled against. With a default, there is the risk that a country will also break contracts in other areas of the economy, which could hurt US investors. Hence, to send a signal that behavior that hurts investors will not go unnoticed, judges will rule against the defendant. In addition to economic ties, regime type is another important characteristic. Democracies are less likely to be ruled against than authoritarian regimes because the decision to default appears to be more legitimate due to institutional constraints in democracies. Plaintiffs are less likely to win a case when the defendant is a democracy.

Nevertheless, conservative judges are more likely to rule against the defendant than liberal judges. Presidents nominate judges that they believe have similar beliefs to their own, so a left-right divide will also be present among judges. As export-oriented businesses have supported the Republican party since the 1970s, conservative judges are likely to rule in such a way that maintains free market norms. Furthermore, since it is democracies that attract the most intra-industry trade, it is these group of countries where the difference between conservative and liberal judges are most stark. Conservatives want to uphold free market norms where there is the greatest amount of economic ties with the United States. In contrast, liberal judges give democracies the benefit of the doubt in their decision to default and permit the decision to default to remain a domestic issue.

There are policy and normative implications for the lack of impartiality in sovereign debt litigation cases. The most glaring issue is that state sovereignty is being infringed upon by US judges. While most countries that are involved in the global economy have lost some sovereignty, that is a choice. A country chooses to go to the IMF in exchange for loans. With the FSIA, it is non-state actors that are dragging

a sovereign state to court. Once at court, a judge can enact measures that force the hands of a state to pay all its creditors, including the vulture hedge funds. The concern is that vulture funds will continue to take advantage of a state in distress and make economic crises worse. In the shadow of a looming debt crisis due to COVID-19, the lack of rules or guidelines to manage vulture funds is problematic. When a conservative judge rules in favor of a plaintiff that is a vulture fund, they are rewarding unscrupulous behavior and, therefore, could encourage such behavior. Vulture funds are not hedge funds who made an investment prior to a crisis.

Despite the violation of sovereignty and the predatory behavior of vulture funds, US judges could be potentially good for economic development. A ruling against the defendant and for the plaintiff could reassure investors such that they do not flee a country during an economic crisis. As a consequence, countries that are ruled against may experience quicker economic recovery than those that escaped a negative ruling either due to being a democracy or not having strong economic ties with the United States. While a ruling in the favor of the defendant may benefit politicians in the short-term because their hands are not forced, there may be economic benefits for the defendant if they are ruled against.

Appendices

Appendix 1A

Names of Entities Included in Scrape

Republic of Costa Rica

Cote D'Ivoire

The Republic of the Ivory Coast

Democratic Republic of Congo

Central Bank of the Democratic Republic of the Congo

The Bank of Zaire

The National Bank of Congo

The Republic of Zaire

Dominican Republic

The Commonwealth of Dominica

The Republic of Ecuador

Arab Republic of Egypt

Republic of El Salvador

Republic of the Gambia

The Republic of Ghana

Hellenic Republic

Grenada

Republic of Guatemala

El Banco DE Guatemala

Republic of Guyana

Republic of Honduras

The Republic of Hungary

Republic of India

Republic of Indonesia

Republic of Iraq

Italian Republic

Jamaica

Japan

Republic of Kenya

Republic of Korea

Republic of Liberia

The Republic of Liberia

Meridien Bank Liberia Limited

Liberian National Petroleum Company

Government of The Republic of Liberia

Malaysia

Republic of Mauritius

United Mexican States

Kingdom of Morocco

Kingdom of the Netherlands

New Zealand

The Republic of Nicaragua

Republic of Nicaragua

Banco Nicaraguense

Banco Nacional De Desarrollo

Republic of the Niger

Republique Du Niger

Federal Republic of Nigeria

Kingdom of Norway

Islamic Republic of Pakistan

Republic of Palau

Republic of Panama

Republic of Paraguay

La Republica De Paraguay

Republic of Peru

Banco Del Sur Del Peru

Petroleos Del Peru

Republic of the Philippines

Republic of Poland

Republic of Portugal

Romania

Russia Federation

Republic of Sierra Leone

Republic of Singapore

Federal Republic of Somalia

Republic of South Africa

Republic of South Sudan

Kingdom of Spain

Democratic Socialist Republic of Sri Lanka

Republic of the Sudan

Bank of Sudan

Somali Democratic Republic

Kingdom of Thailand

Republic of Tunisia

Republic of Turkey

Republic of Uganda

Oriental Republic of Uruguay

Bolivarian Republic of Venezuela

Socialist Republic of Viet Nam

Republic of Yemen

Republic of Zambia

The Republic of Zambia

Bank of Zambia

Republic of Zimbabwe

Rafidain Bank

Central Bank of Iraq

Petroleos De Venezuela

Appendix 1B

Figure 4: Model 1 Country Effects

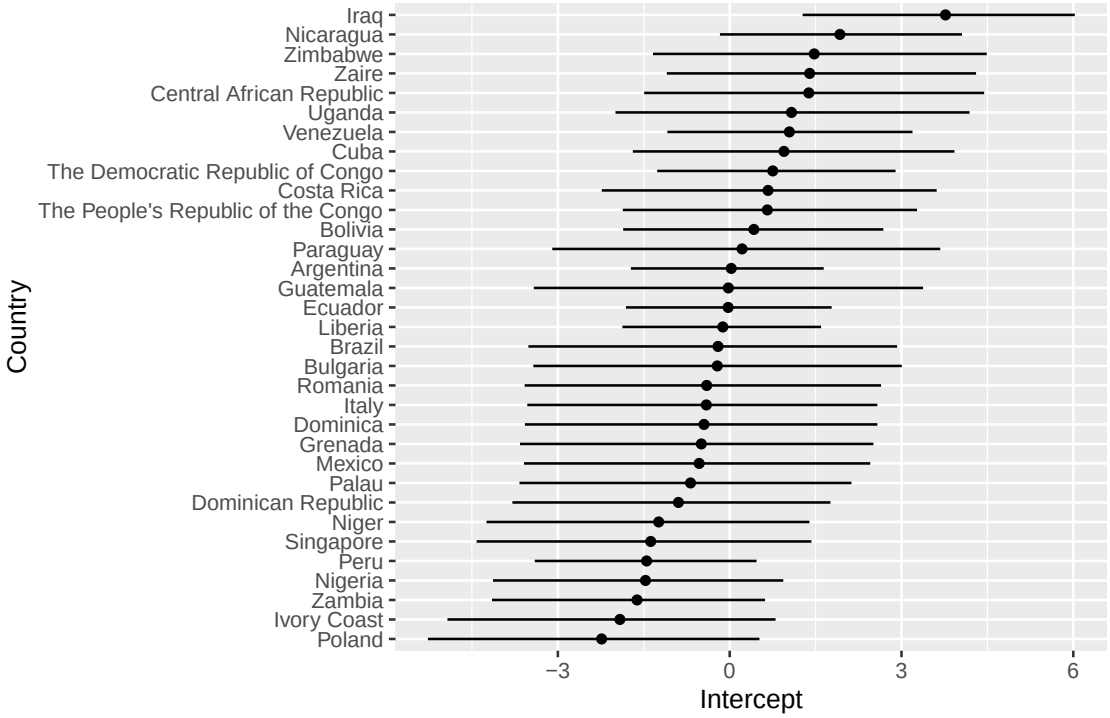


Figure 5: Model 1 President Effects

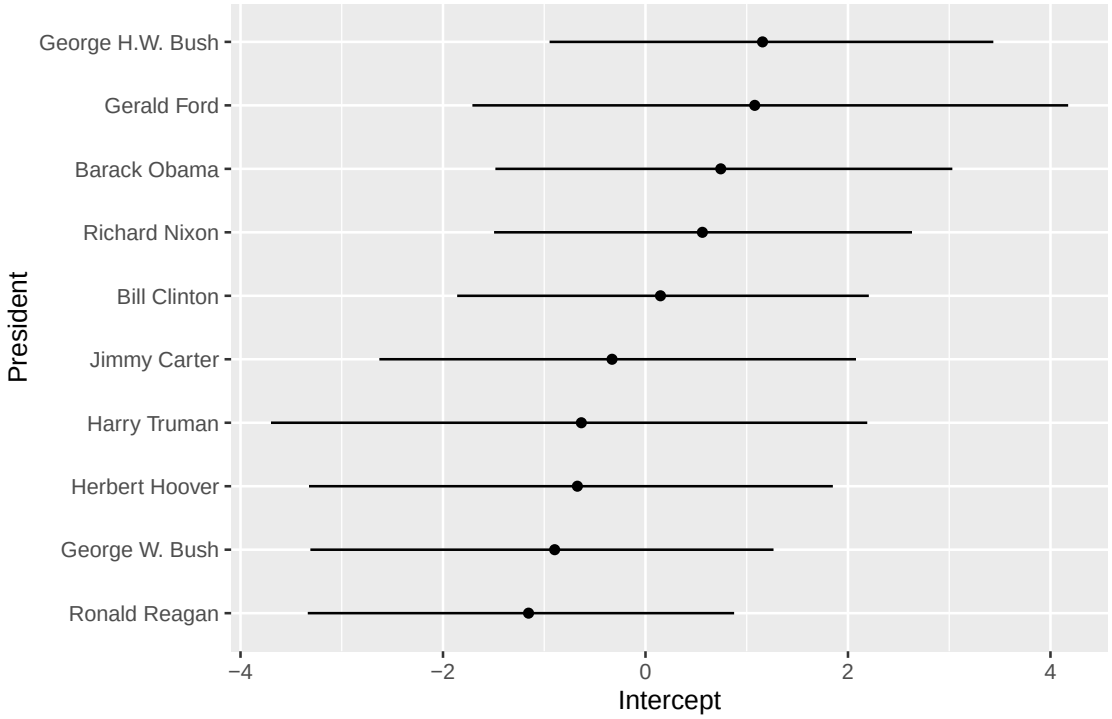


Figure 6: Model 1 Judge Effects

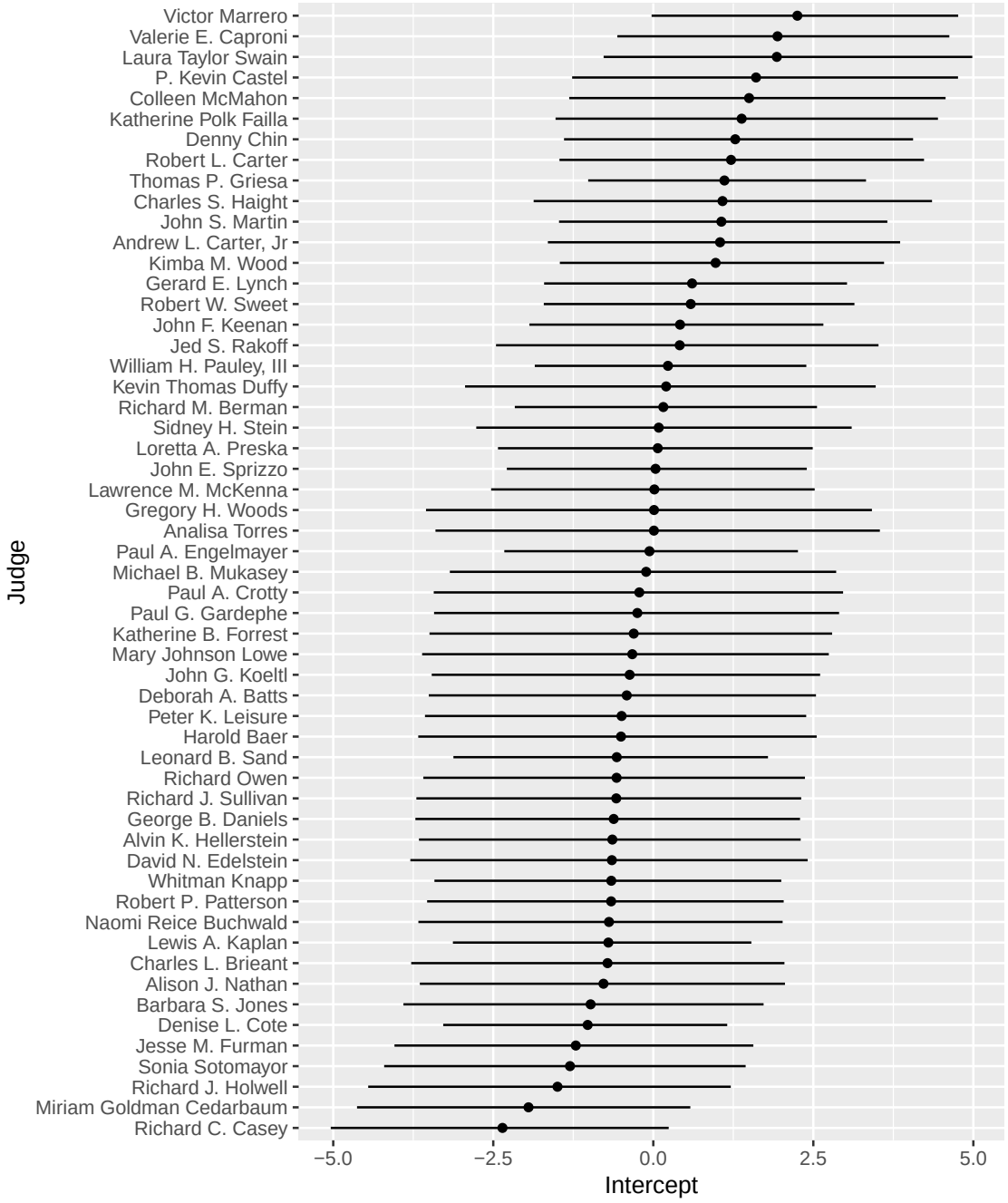
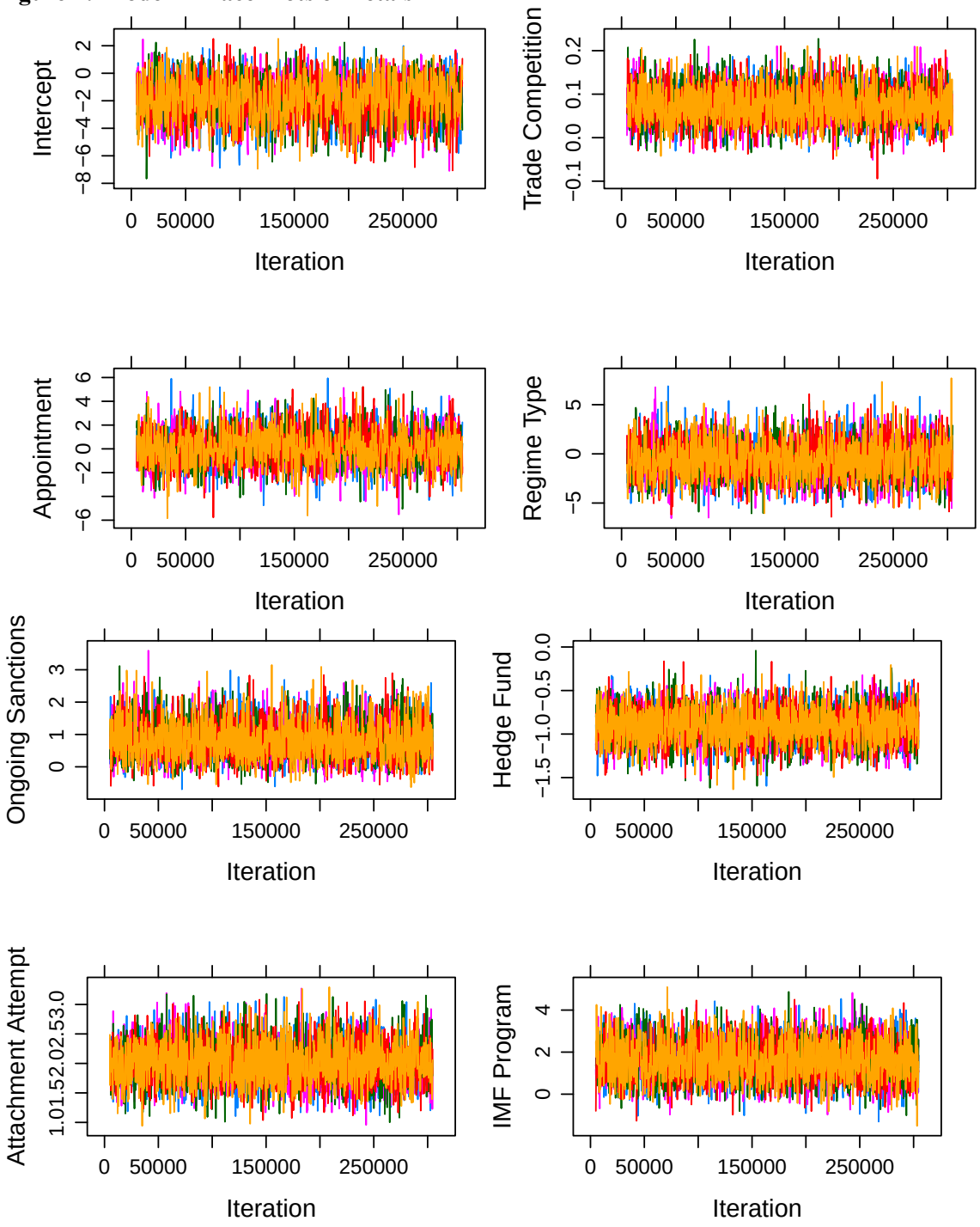
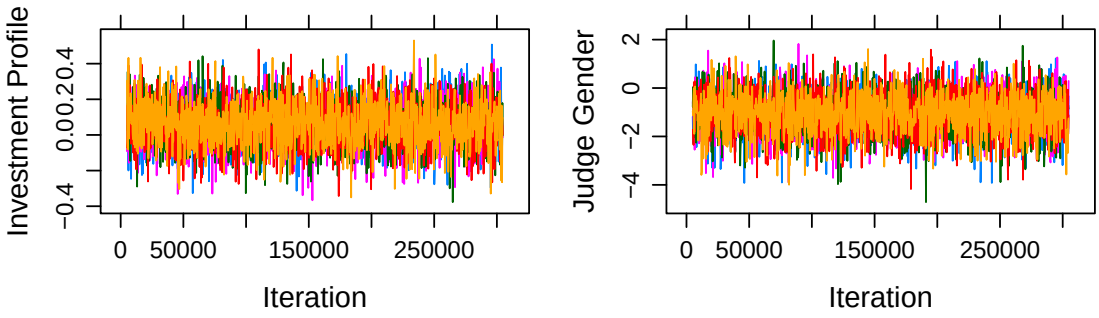


Figure 7: Model 1 Trace Plots of Beta's

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Iteration
Judge Gender
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150000
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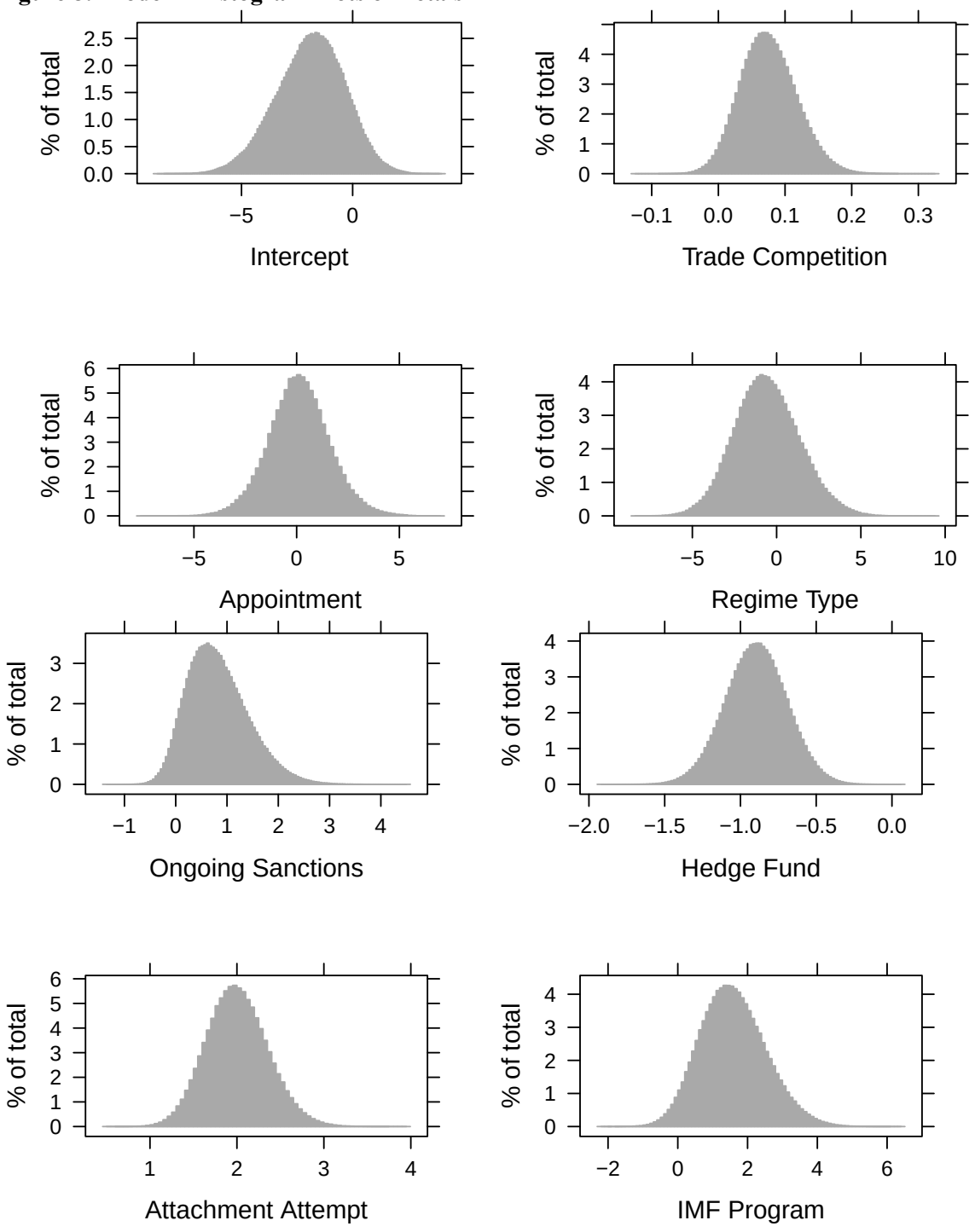
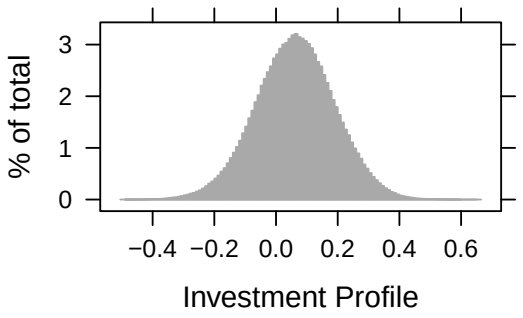
Iteration

Figure 8: Model 1 Histogram Plots of Beta's

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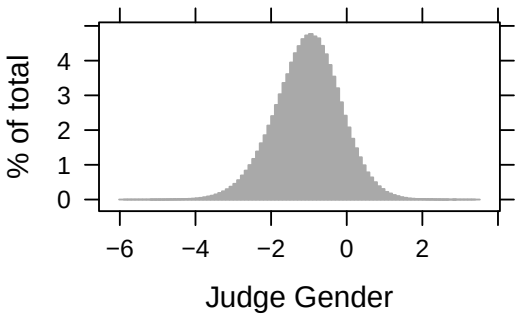
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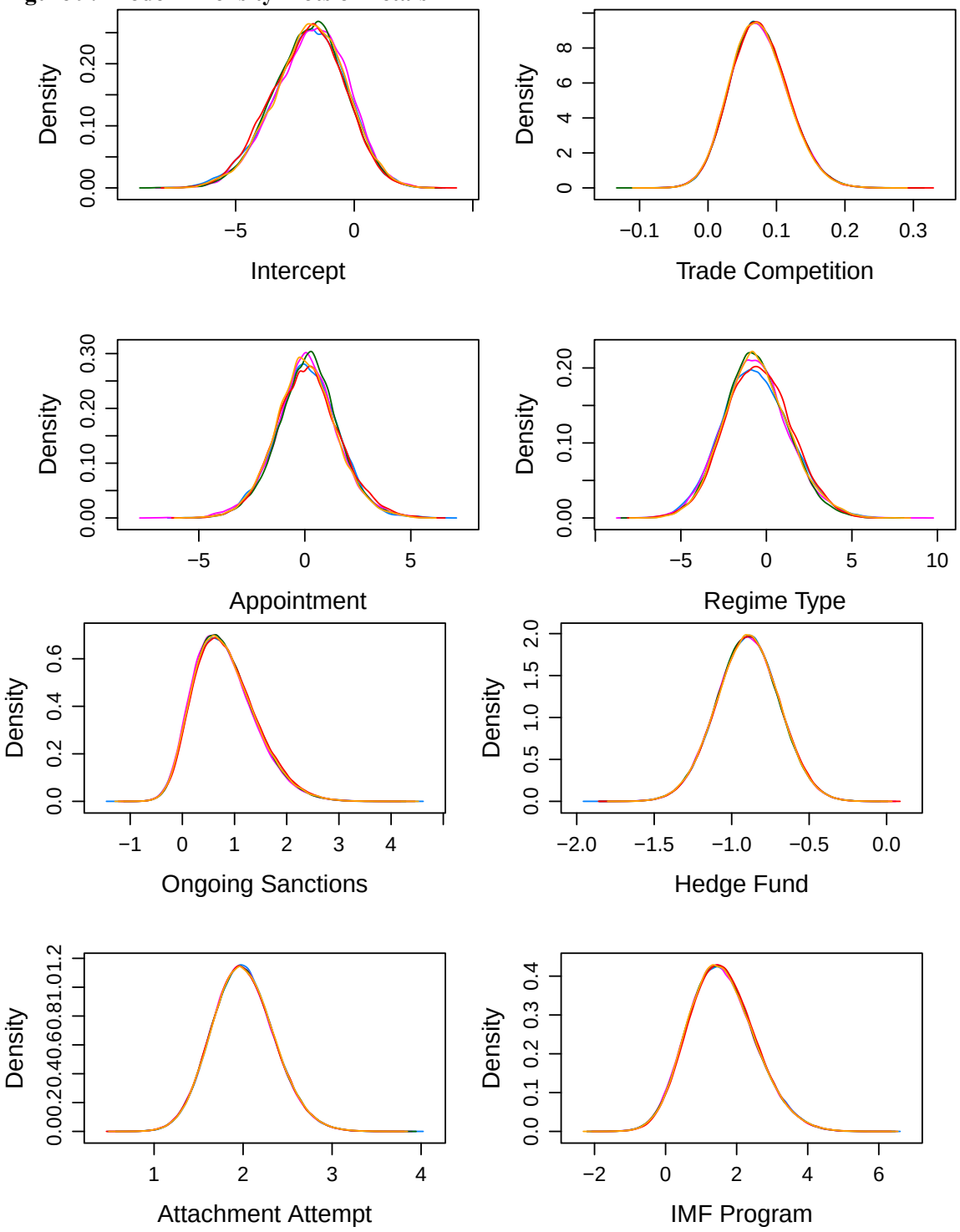
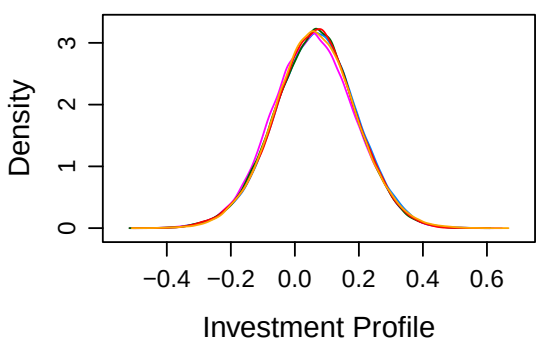
Judge Gender

Figure 9: Model 1 Density Plots of Beta's

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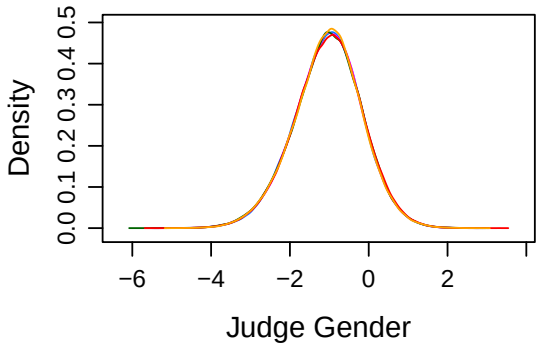
Investment Profile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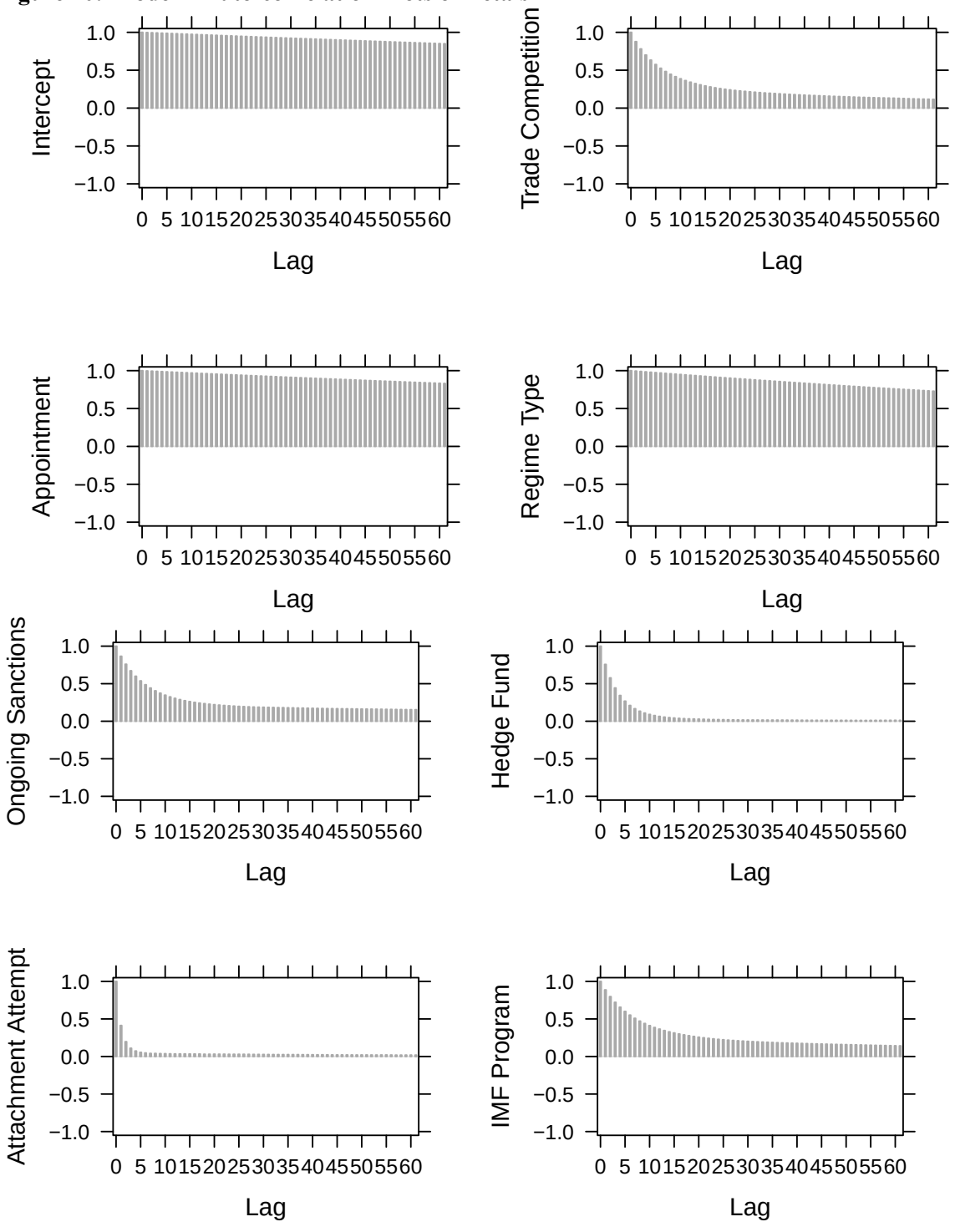
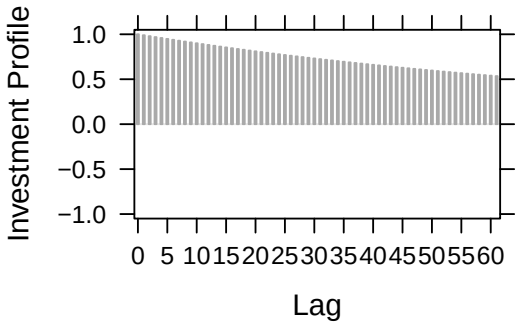
Judge Gender

Figure 10: Model 1 Auto-correlation Plots of Beta's

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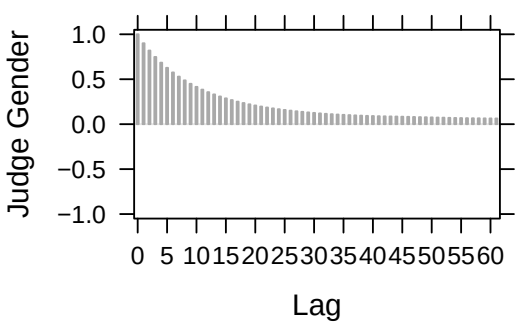
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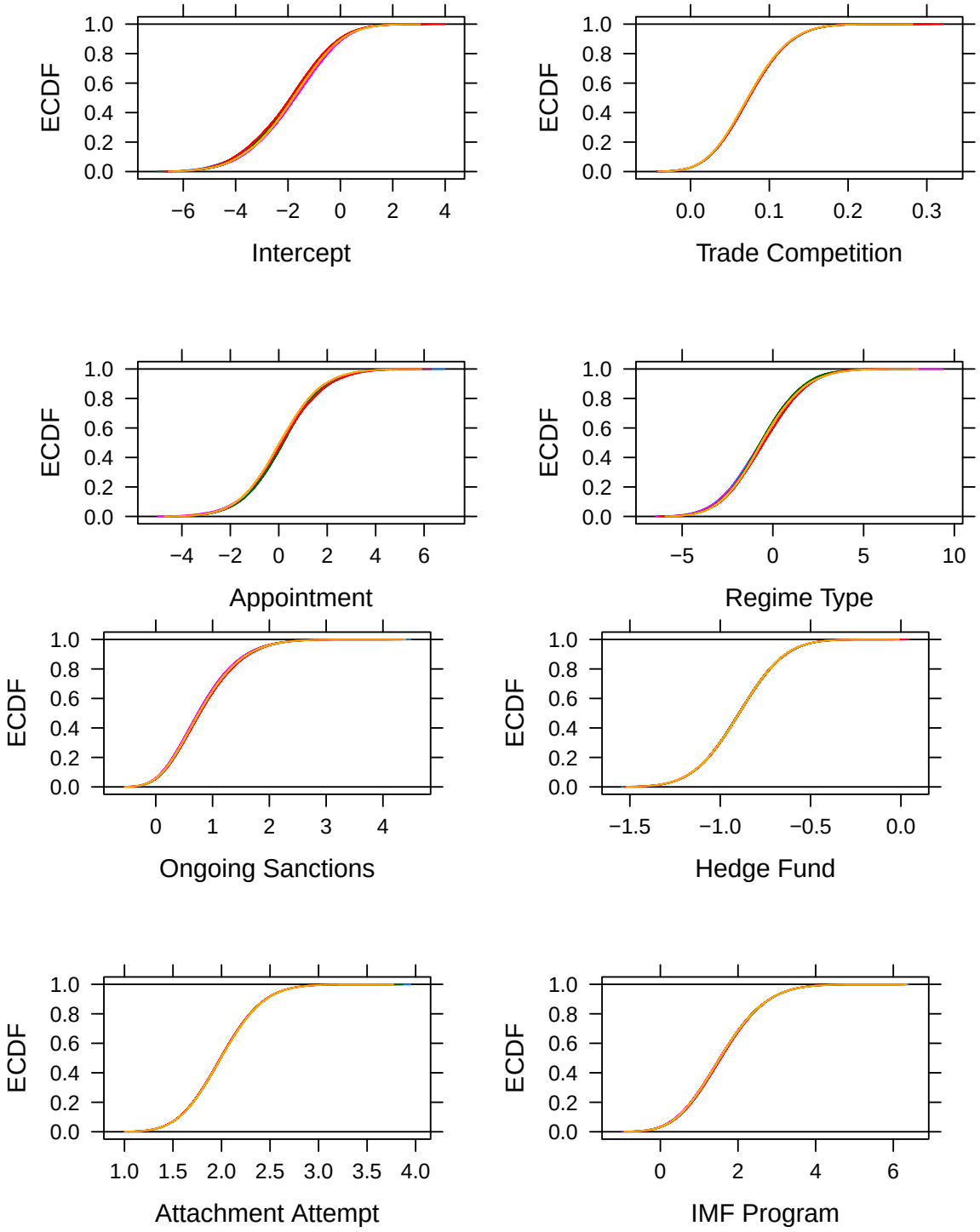
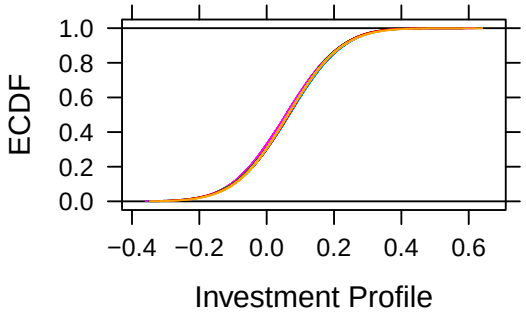
Lag

Figure 11: Model 1 ECDF Plots of Beta's

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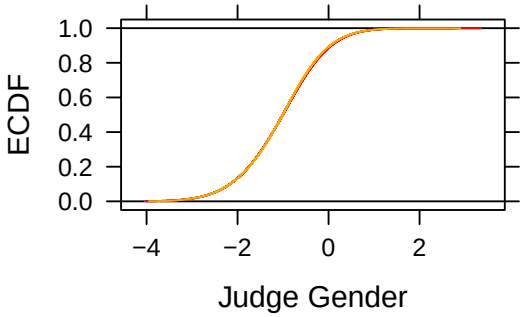
Investment Profile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Judge Gender

Appendix 1C

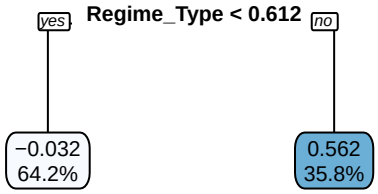
Table 6: Bayesian Hierarchical Model - President and Country Effects

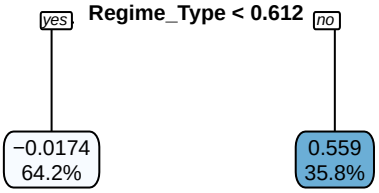
	Mean	SD	Lower95	Upper95	P>0	MCerr	MC%ofSD	SSeff	psrf
Intercept	-1.11107	1.16390	-3.46163	1.10225	0.16406	0.02001	1.7	3382	1.00128
Trade Competition	0.05727	0.03554	-0.00831	0.13021	0.95840	0.00021	0.6	27367	1.00005
Appointment	0.29200	1.05966	-1.82019	2.45116	0.60522	0.01656	1.6	4096	1.00133
Regime Type	-1.60219	1.34833	-4.22207	1.07598	0.11772	0.01524	1.1	7825	1.00029
Ongoing Sanctions	0.42358	0.41645	-0.30131	1.28079	0.85026	0.00299	0.7	19375	1.00001
Hedge Fund	-0.86649	0.18934	-1.24028	-0.50016	0.00000	0.00090	0.5	43901	1.00002
Attachment Attempt	2.08235	0.33349	1.44240	2.74360	1.00000	0.00153	0.5	47661	1.00002
IMF Program	1.15652	0.66549	-0.10254	2.48515	0.96904	0.00422	0.6	24878	1.00024
Investment Profile	0.09609	0.10760	-0.11188	0.30928	0.81498	0.00108	1.0	9888	1.00028
Judge Gender	-1.04364	0.43847	-1.89115	-0.16607	0.00614	0.00238	0.5	34010	0.99998

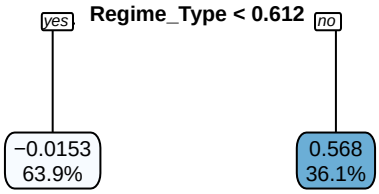
Table 7: Bayesian Hierarchical Model - Polyarchy

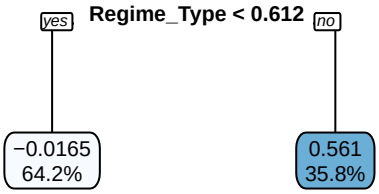
	Mean	SD	Lower95	Upper95	P>0	MCerr	MC%ofSD	SSeff	psrf
Intercept	-1.68380	1.56744	-4.86951	1.19531	0.13988	0.03603	2.3	1892	1.00091
Trade Competition	0.07380	0.04267	-0.00591	0.16036	0.96786	0.00030	0.7	19922	1.00051
Appointment	0.15699	1.43493	-2.61747	3.12660	0.54456	0.02877	2.0	2487	1.00122
Regime Type	-0.98271	1.74822	-4.27085	2.51412	0.28278	0.03271	1.9	2857	1.00180
Ongoing Sanctions	0.78837	0.57827	-0.23595	1.94831	0.93682	0.00519	0.9	12405	1.00058
Hedge Fund	-0.89940	0.20157	-1.30363	-0.51219	0.00000	0.00094	0.5	45654	1.00006
Attachment Attempt	2.01976	0.35031	1.32358	2.69313	1.00000	0.00170	0.5	42349	1.00012
IMF Program	1.58548	0.92170	-0.11158	3.45278	0.96908	0.00700	0.8	17313	1.00039
Investment Profile	0.07671	0.12915	-0.17644	0.32926	0.72672	0.00151	1.2	7291	1.00043
Judge Gender	-1.00163	0.86675	-2.76212	0.68510	0.11582	0.00525	0.6	27257	1.00002

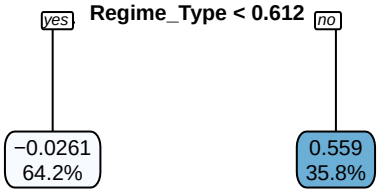
Appendix 1D: Virtual Twins and Varieties of Democracy Liberal

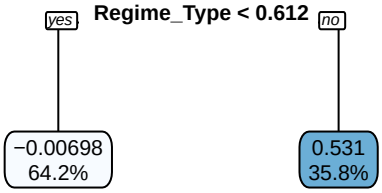


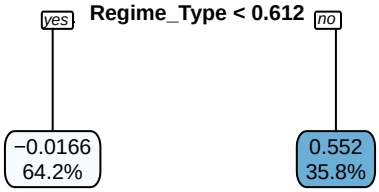


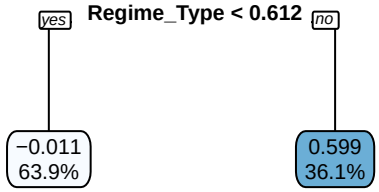


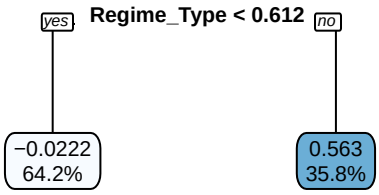








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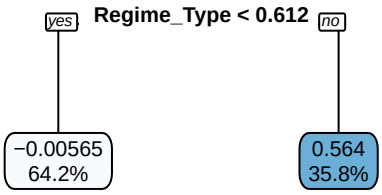
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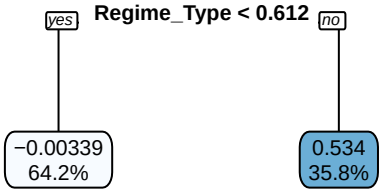
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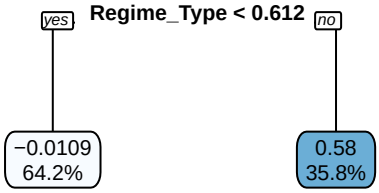
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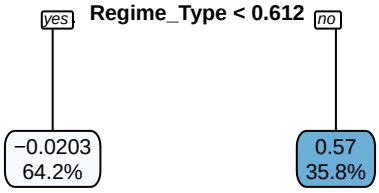
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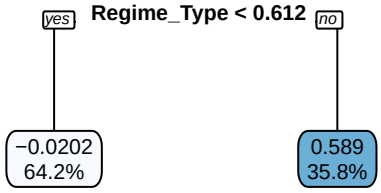
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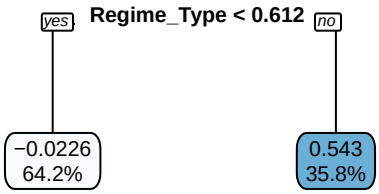
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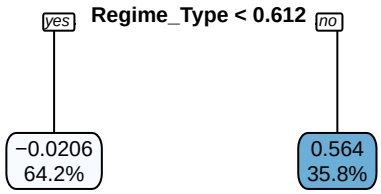
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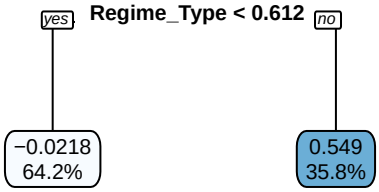
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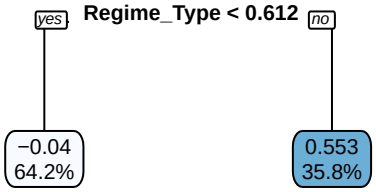
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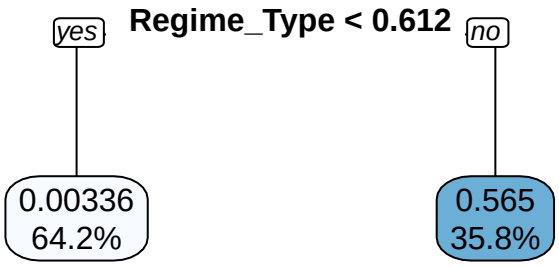
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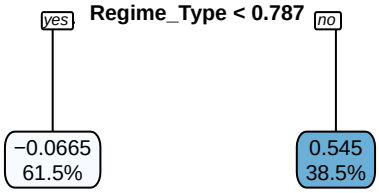
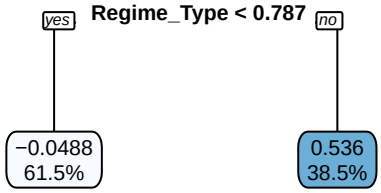
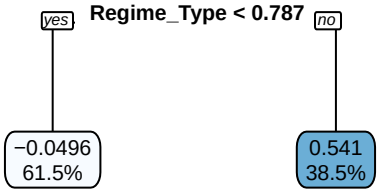
Appendix 1E: Virtual Twins and Polyarchy Measure of Democracy

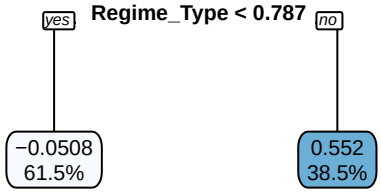
Table 8: Virtual Twins Results - Polyarchy

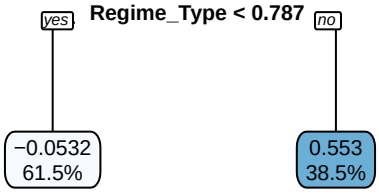
	Estimate	SE	Lower CI	Upper CI	P-Value
RM Subgroup	0.6771	0.0037	0.6697	0.6844	0.0000
SND Subgroup	0.5620	0.0232	0.5166	0.6075	0.0000
Overall	0.0855	0.1163	-0.1425	0.3134	0.4624

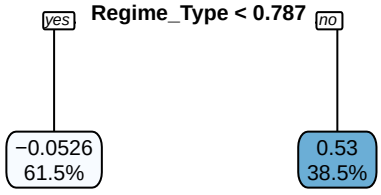


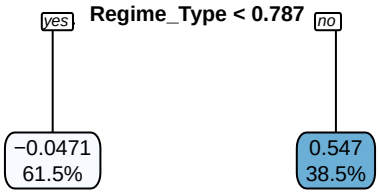








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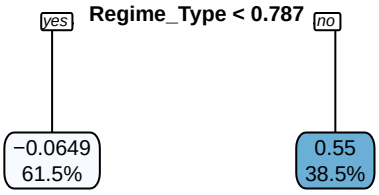
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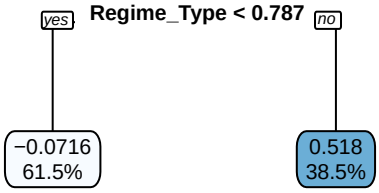
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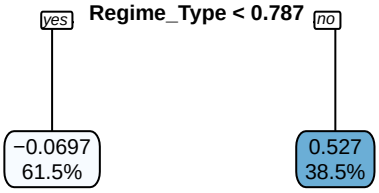
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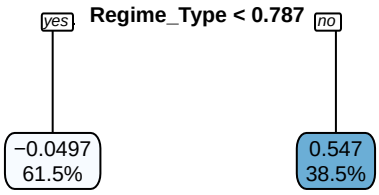
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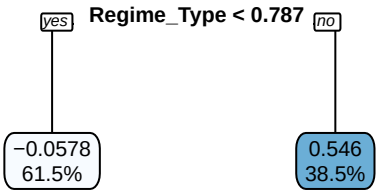
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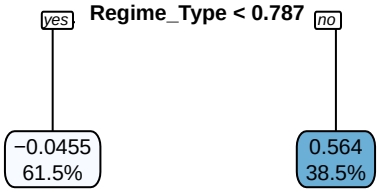
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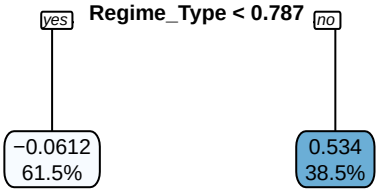
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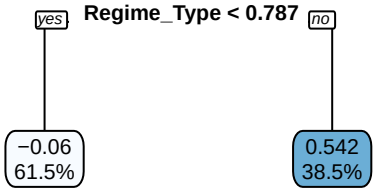
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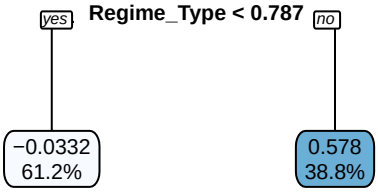
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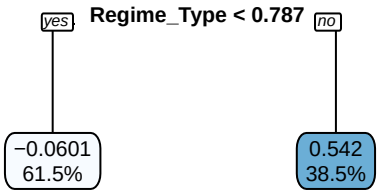
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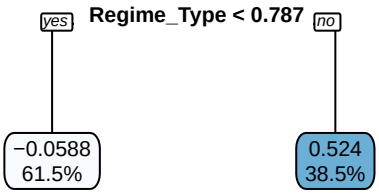
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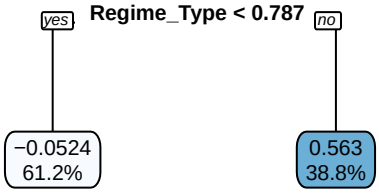
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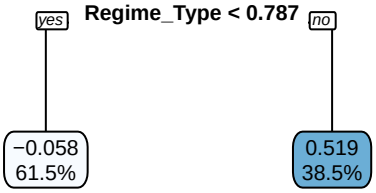
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