Vulture Diplomacy:
Distressed Sovereign Debt, Creditor Coalitions and the London Stock Exchange in the 19th century

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This paper lays the foundations of a new approach to the history of sovereign debt in the 19th century as what I called "vulture diplomacy". It suggests reconsidering the 19th century experience with sovereign default. It was not a tale of incompetent investors with a short view and a shorter memory defrauded by "serial defaulters" but one of the sophisticate operations of first class speculators belonging to the wealthiest "1%". I demonstrate how the London stock exchange enabled these wealthy foreign debt vultures to transcend sovereign immunity. This casts doubt on the view that "sovereign immunity" prevented creditors from going after defaulters. A detailed case study provides a measurement of the effects of such tactics. I show that distressed debt investors were able to tamper with the politics of the target and managed to extract significant value. I also report evidence consistent with looting. Distressed debt investing was a profitable business and a critical element of British imperialism.

* Howard S. Marks Professor of Economic History, University of Pennsylvania. This paper evolved over the course of many years and many ruminations. I wish to express my warm thanks to Vincent Bignon and Carolyn Biltoft for their support throughout and to Fredric Zumer for initial inspirational conversations and work. He identified the material for the foundational surprise out of which the present paper grew. I am also grateful to Howard Marks for the insights he shared on high yield and distressed debt investment. They played a critical role in enabling me to interpolate motivations despite an exceedingly fragmentary historical material, and begin to re-read, as I have done here, the history of default and sovereign immunity in what I think is a radically new way. Remarks on a previous paper by Naomi Lamoreaux also played a significant role too in enabling me to see how to structure the arguments offered here here. The wonderful archivists of the Guildhall Library, to those of the Portuguese National Archive at Torre do Tombo and to Justin Cavernelist-Frost at the Rothschild Archive for their support and help. Excellent research assistance by Helena Carvalho in Portugal is gratefully acknowledged. I express much gratitude to Prof. Maria Eugenia Mata for her insights on the dynamics of Portuguese finances and to Howard S. Marks for discussions that enabled me to enter more deeply into the logic of distressed debt investing. Nothing in this paper should implicate them. Great thanks are also due to the team at Bodhi Coffee, 2nd Street, Philadelphia, where the coffee is always hot and the music always good. Their cheerful inquiries as to "whether I had made any progress today?" as I muddled through an initially sinuous argument provided me for reasons to persist.

In *The City; Or, The Physiology of London Business*, first published in 1845, City journalist David Morier Evans has provided a vivid portrait of a little-known Victorian millionaire, Richard Thornton (1776-1865), a self-made man who had amassed his initial wealth during the French wars through commodity trading and the running of the Continental blockade.[1] Thornton can be recognized as a forerunner of modern "foreign debt vultures" as hedge funds specializing in distressed sovereign debt are known critically today. Following the collapse of the first foreign debt boom in the 1820s, Thornton became a very large holder of defaulted debt.[2] At that point he launched a career as and activist bondholder, helping in a "handsome manner" creditor protective committees he often chaired.[3] This paid handsomely, too. Around Evans 1845, Evans was already describing Thornton as standing "A1" in terms of wealth. Twenty years later, at the end of 35 years of extensive interventions in the market for distressed sovereign debt, Thornton left behind him a staggering fortune valued by probate at £2.8 million, the largest British fortune recorded before 1870.[4]

When I came across this description some years ago, I was struck by the strange manner in which it resonated against existing economic views on the history of sovereign debt. The literature centers around what it calls the "sovereign debt puzzle" a popular theory that asks why sovereign debts exist when sovereigns have no reason to repay them. As the story goes what stands in the way of sovereign debt is, first, a problem of pre-commitment. Sovereign borrowers are protected by sovereign immunity, which makes it difficult to secure a judgment against them. And even if courts listen, enforcement is problematic. Next, the externality interacts with coordination problems among creditors. As argued in an extremely influential paper by Bulow and Rogoff (1989), in a world where markets are perfect, nothing prevents a sovereign from borrowing with one agent, then defaulting and switching to the next. This prevents monitoring and causes the collapse of sovereign lending. Against this backdrop, sovereign debt comes into existence either because investors are naive (See Reinhart and Rogoff 2008) or because the governments of creditor countries apply political sanctions (Bulow and Rogoff 1989).

It has often been suggested that the 19th century offered a particularly relevant world to discuss the sovereign debt puzzle. British courts of justice adhered scrupulously to an extreme form of sovereign immunity described as "absolute sovereign immunity" (Gulati and Weidemaier 2014).[5] What is more, bondholder protective organizations were seriously undermined by collective action problems. American legal scholars Borchard and Wynne have depicted these organizations as ephemeral", ad hoc and fragile (Borchard and Wynne 1933). In one influential rendering of this account proposed by Eichengreen and Portes (1986, p. 622) early bondholder representation was plagued by "rivalry among competing committees [which] undermined the credibility of each."[6] Mauro and Yafeh (2003) have suggested that it was only after 1873 when the Corporation of Foreign Bondholders was put together with British government support that the outlook for bondholders started to improve. Yet the literature remains pessimistic. The prevalent view is that the dispatch of the gunboat or the use other forceful political means played a crucial role in repayment (Mitchener and Weidenmier 2006, 2010, Ahmed, Alfaro & Maurer 2010).[7]

The British lion, in summary, did the work. But these accounts never speak of vultures. A distressed debt investor crucially needs a court, to uphold his property right. He also needs a bankruptcy procedure because this is the place where distressed debt can be swapped for control and help improve the value of the investment. How could distressed sovereign debt investors exist where there was no sovereign debt tribunal? This alternative puzzle provided the original motivation for looking beyond existing narratives (Flandreau 2013). It soon emerged that Thornton was not an isolated bird. The bondholders, far from being helpless groupings engaged in cutthroat competition were a concentrated, wealthy and ubiquitous distressed debt "mafia" that included a handful of successful bosses, exemplified by the wealthy Thornton (Flandreau 2013, Flandreau and Gamboa 2020). Taking cue from Evans' hint that Thornton saw something we did not and (he writes that Thornton's success resulted from something more than mere fortune"), I began to reconstruct an alternative universe, which would enable me to make sense of Thornton and his associates. The result is this paper, which I offer as a departure from the existing literature but more profoundly, a new agenda, too.

The bottom line is that this is a challenge to the conventional sovereign debt puzzle. I suggest a radical rethink of the history of sovereign debt during the first half of the 19th century. Creditors had significant ability to uphold their rights. In particular, they did not suffer from the supposed free riding problem. This was owing to the existence of a powerful institution, the London stock exchange committee. While its role in policing the trading of stocks has been well emphasized before (Ferguson 1984, Neal 2006, Stringham 2015), recognition of its relevance to sovereign debt is new (Flandreau 2013). As I will demonstrate, the stock exchange turned out to act as a *de facto* court of sovereign debt bankruptcy. It provided the legal venue, which distressed debt investors could exploit.

This arose despite the fact that the committee did not have the power to "enforce" its decisions in any traditional sense. However, pretty much like early guilds or merchant courts, it had the power to govern its members. This proved essential in order to prevent free riding in sovereign debt. Recall that in standard public economics models, it is the inability to discriminate against free riders that causes the under-provision of the public good. In the context of sovereign debt, free riding arises if anyone can lend to a defaulter *and* join the pool of creditors with equal rights. If this is the case, then creditors loose the ability to monitor borrowers, because each creditor has the right to undermine the next. But because coalitions hold the power to exclude, they are able to prevent this from happening. All they need to do is exclude the "cheater". Given this, the free riding apocalypse haunting previous narratives needs not be destiny.

From a theoretical point of view, the basic intuition on which my argument rests can be distilled in relation to the works of Paul Milgrom and Avner Greif on the role of merchant guilds in supporting long distance trade in the Middle Ages (Milgrom, North and Weingast 1990; Greif, Milgrom and Roberts 1992).[8] The reason for the analogy is that both in the case of long distance private medieval trade and modern sovereign debt, there is a pre-commitment problem (although I remark that the analogy has never been recognized before). Theoretical studies of guilds suggest they acted as coalitions that addressed pre-commitment problems. They enabled trade to expand to its efficient level by coordinating the responses of merchants to transgression and by ensuring the solidarity of incentives among merchants. A particularly important argument is Avner Greif's famous "cheat the cheater" strategy, which he articulates in the context of his study of the Maghribi traders' coalition (Greif 1993). A "cheater" who broke the rules of the coalition, because he was excluded from the group, ends up in an enforcement poor environment. He is now exposed to being "cheated" by third parties because he can no longer enjoy the protection of the coalition. The risks associated with ending up in this unenviable situation provide incentives to cooperate.

I make a similar argument in the realm of sovereign debt. The stock exchange committee harnessed the "cheat the cheater" logic by creating a rule in February 1827 that excluded loans to defaulters from its purview. The rule prevented a defaulter from raising a new loan unless it had offered a satisfactory arrangement to its London stock exchange creditors. I argue that the objective of the statute was to deprive free riders from the protection afforded by the coalition, which the stock exchange committee upheld. An individual capitalist could break away and lend to a defaulter, but then she would be on her own. Loans that would bypass the interdict would have junior status. In particular, holders of pariah loans were exposed to being cheated by the sovereign because there were few reasons to repay the holders of an isolated debt. Short of duplicating the stock exchange coalition, which incurred large set up costs, the holders of pariah loans enjoyed no protection at all. Recognizing this, investors desperately to join the club (hold official loans) in order to avoid the costs of bilateral negotiations with sovereign borrowers.[9]

Next, I argue that the stock exchange committee developed an approached that mimicked in the realm of sovereign debt the formal process of bankruptcy regimes. In fact, it something not unlike what has been advocated more recently by the IMF and is known as the Krueger proposal for a sovereign bankruptcy mechanism (Krueger 2002). First, the committee served as a venue for the resolution of disputes among creditors and occasionally between creditors and debtors. In particular it recognized and upheld creditors priorities, the default rule being the equal treatment of creditors. Second, it encouraged creditors and debtors (through their financial or diplomatic representatives) to get together on their own accord and negotiate. Third, because the stock exchange committee controlled the readmission of defaulters if they had offered a satisfactory arrangement it could monitor the injection of new cash. In particular the upholding of group behavior and the readiness to address creditor disputes enabled to write demanding and credible conditionality clauses. The result was that the stock exchange committee could, so to speak, certify the quality of the debt restructuring process, thus assisting with the resolution of debt crises.

This availability of quasi-Chapter 11 procedures explains the interventions of sovereign debt vultures. In this paper, I will argue that 19th century distressed sovereign debt investors may be thought of as having borrowed (or more appropriately, anticipated) a page from the modern corporate distressed debt investor playbook. A relevant template is the so-called "distressed-for-control" tactics, which have been developed in the recent past (Harner, Harner, Martin, and Singer 2013). Specifically, I will argue that the law of the stock exchange enabled the growth of a private business consisting in what I describe as sovereign debt restructuring originations. Investing in defaulted government debt gave forerunners of modern hedge funds the option to secure access to the jurisdiction of the committee. Relying on this jurisdiction and its demonstrated willingness to enforce creditor cooperation, restore market access and support capital injections that could credibly turn a country around, distressed investors organized ambitious and profitable raids on sovereign defaulters.

In traditional game theoretic analyses of sovereign debt bargaining, sovereign debt-holders are pitted against a well defined and ill-willing foreign defaulter, and they suffer from a coordination problem. In the alternative historical approach I articulate in this paper however, creditors are found to have been well governed, capable of transcending collective action problems, and supported by a de facto sovereign debt jurisdiction (the stock exchange committee). This enabled them to implement loan-to-own raids, because the sovereign debt jurisdiction did recognize and enforce the prior rights to holder of defaulted obligations.

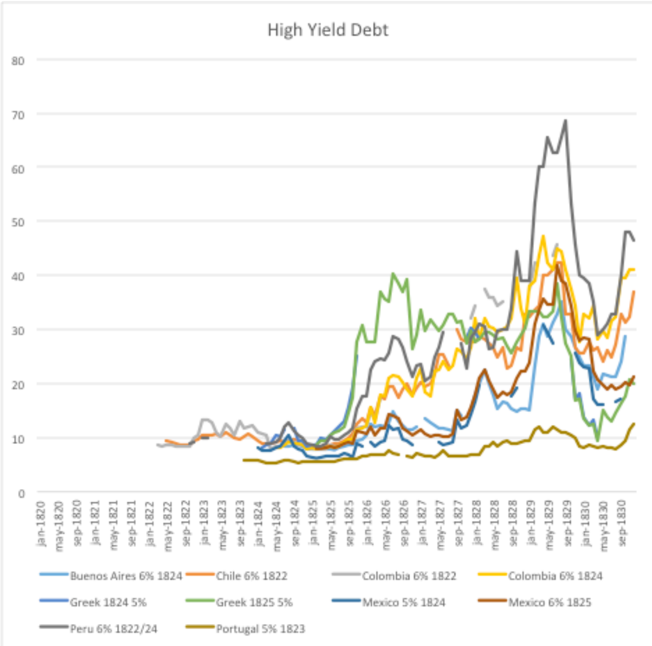
In this paper, I draw extensively on a characteristic episode of sovereign distressed-for-control, which took place in 1831-1833. The occasion was provided by a conflict that pitted against one another two rival brothers who vied for the crown of Portugal. One was Dom Miguel, the *de facto* King of Portugal and the other Dom Pedro, the former Emperor of Brazil who had just abdicated. An alliance of distressed debt investors, insiders of the London stock exchange committee and political entrepreneurs offered Pedro the means to get rid of Miguel, the condition being that he would indemnify the holders of a Portuguese debt. A contract featuring a conditionality arrangement was submitted to the stock exchange committee and approved. Significantly, Pedro later identified this contract as the pivotal element in his victory over Miguel.[10] But what had led investors in the London stock exchange to trust Pedro, the representative of a self-proclaimed, insurgent government?[11] The answer I give is that the stock exchange committee had made the pledge credible through its ability to coordinate creditors. Money was only released upon Pedro reaching successive credit enhancing targets.[12]

The remainder of the paper…

Section I. Distressed-for-Control and the Credit Cycle

My story begins with the crash, in late 1825 of what Dawson has described as the "first foreign debt bubble." Since the early 1820s new sovereign borrowers had appeared in the market. They were a diverse lot and this was reflected in spreads. Some, underwritten by prestigious underwriters, had been issued at yields that were about 100 basis points only above British yields. But for the others, originated by a number of enterprising brokers and merchant bankers who distributed them predominantly among their friends and networks of clients, had spreads that could go as high as 600 basis points.[13] With the debt monetary crisis of 1825-26 however, a wave of defaults occurred. One after the other, the new sovereign loans fell into arrears. By the end of the decade, of the 15 countries that had issued a total of 23 individual loans in the London stock exchange, 9 were in default, representing a total of 15 individual loans. Yields on such securities exploded (Figure 1).[14]

Figure 1. Yields on Defaulted Sovereign Bonds (1820-1830)



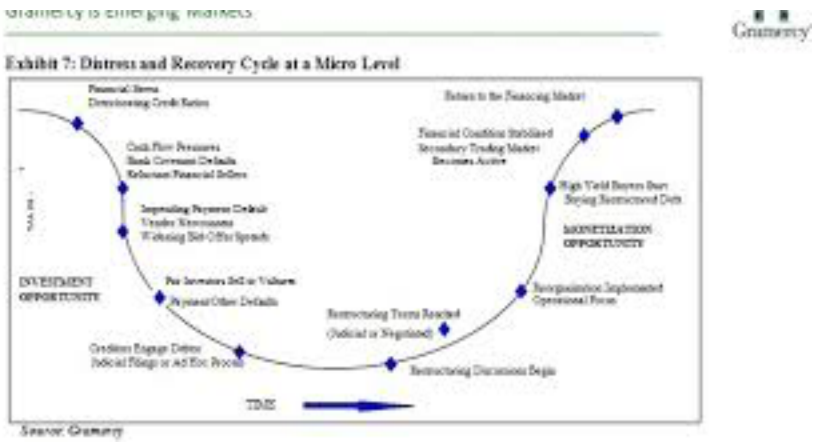
Source: Author

Investors panicked and the usual criticism against the stock exchange's failure to prevent the bubble was heard. In a contemporary libel lawsuit the exchange was dubbed a "National Hell". [15] Meanwhile, a group of prominent members of the London stock exchange who were significant holders of defaulted foreign government securities decided to take their fate into their own hands. They knew perfectly well that sovereign immunity deprived them of conventional remedies.

Instead, what they did was lobbying the jurisdiction of the stock exchange committee, of which some of individuals in the group were members, to create a statute that would bar defaulters from tapping the market anew, unless they had offered compensation to creditors. As the petitioners emphasized, their chief concern was preventing dilution of their rights, if new lenders were allowed to join the pool of creditors. The result was the creation, on February 27 1827 of a new entry in the *Rules and Regulations of the Stock Exchange*.

To understand the thoughts, which began to emerge in the minds of these sophisticate investors, I suggest to cast the matter in terms of the so-called "distressed debt cycle" (Figure 2), a popular concept among distressed debt investors. Some distressed debt investors refer to the work of Charles Kindleberger as motivating this approach (Marks 2018). During booms or manias, high yield instruments are issued, sometimes indiscriminately. Then comes the downturn, precipitated for instance by realization that performance does not keep up with expectations or by other macroeconomic or structural factors (a rise in interest rates or the revelation of unsound lending or accounting practices). The stampede begins, leading to credit downgrades and price declines across the board as institutional investors, constrained by rating or liquidity standards are compelled to sell out.[16]

Figure 2. The Distress Sovereign Debt Cycle



Source: Author, from various contemporary sources

The exaggerated liquidation creates a rationale for entering the market, purchasing instruments as previous investors panic. This is known in the jargon as "contrarianism". The theory is that markets are overreacting. Distressed sale prices enable to contemplate significant recoveries, as the "fallen angels" will rise again. As a result, distressed debt investing is principally about timing. Success requires entering and leaving the market at the right moment and good information about individual investments. Another aspect is the advantage of being able to avoid the "losers" and stick to assets with the largest upside potential. Practitioners emphasize the benefits of acquired intelligence in putting the odds on the investor's side, for instance by dedicated efforts to understand the market in question.

The recovery of the asset is not merely a matter of sitting on one's hands until the outlook changes. As high yield morphs into distress, the entity often comes into bankruptcy and that's a whole different can of beans. It means that distressed debt investors have to navigate the legal system. For instance, under the provisions of Chapter 11 of the US bankruptcy code, creditors of a bankrupt firm are given the option to convert debt holdings into equity and restart the company. When this happens, it is spoken of in the jargon of "distressed for control." In such cases special skills are needed because profits are determined by ability to turn the entity around. The distressed debt investors must now make calls that involve replacing management, selling assets, injecting new capital, and so on. In this case, recovery is made coterminous to the actions of the investor. In terms of Figure 1, this approach may be described as one where debt-holders trigger the onset of the cycle's recovery phase.[17]

One way to do this is popularly known today as "Loan-To-Own" takeover tactics (Harner 2011, Harner et al. 2013). It consists in targeting an entity for which it is precisely believed that the potential for recovery, if the proper actions are performed, is significant. Loan-To-Own corporate raids are curious creatures in that they rely on debt rather than on stock to secure control of a company. This is made possible by the existence of bankruptcy law, which as I indicated in the case of Chapter 11, gives the right to convert debt into equity.[18] From an analytical point of view, the key element is the implicit option embedded in the debt instrument. This option exists, because of the availability of a legal framework, consisting in rules of corporate bankruptcy that make debt holders residual owners of the company. As a result, holding of the company's debt instruments does confer a contingent ownership option. Capturing the importance of the implicit debt-equity swap option triggered by bankruptcy procedures, the modern jargon refers to debt instruments enabling to secure control as "fulcrum securities" (Harner et al. 2013).

The argument I make is that the statute equipped the financial operators who promoted it with tools that enabled them to undertake raids against defaulters. In other words the statute transformed defaulted sovereign bonds into "fulcrum securities." As the next section will argue, under the right conditions, it became possible for distressed debt investors to master the sovereign distressed debt cycle. Through ownership of distressed sovereign bonds, sovereign debt raiders were enabled to weigh on defaulters and even *trigger* debt restructurings, pretty much as happens under distressed-for-control.[19]

Section II. The Origination of Sovereign Debt Restructurings

This section articulates the heart of my argument or theory. I claim that the attitude of the stock exchange committee as a court of justice – and not just the statute of 1827, though it played a crucial part – enabled the coming into being of a of a sovereign debt restructuring mechanism, which may be thought of, for heuristic purposes as a real life anticipation of the proposal which was floated a few years ago by the IMF and which is known as the Krueger proposal (Krueger 2001). The reason is that, first; the stock exchange committee enabled the creation and upholding of creditor hierarchies. Second; By creating a template that encouraged lenders and borrowers to negotiate, it enabled what I call sovereign debt restructuring originations. These permitted debt arrangements that paved the way for the injection of new cash. Third, by using its ruling powers, the committee gave credibility to the resulting programs.

At root, what the stock exchange committee did, was designing a set of property rights, which facilitated the creation and upholding of "creditor clubs" – in essence coalitions of sovereign creditors – organized along defaulting countries lines. This was made possible by the creation of a statute adopted by a vast majority of the members of the committee, on February 28, 1827. The proximate cause was an attempt by a banker to securitize in the London stock exchange a Spanish loan, consisting in a title of indemnity for losses at war, which a number of British citizens had received from the Spanish government, provided the trigger. Believing that official trading of the security would enhance liquidity and would enable holders who wanted to sell, would get a better price, the banker explored with some brokers the possibility of creating a market for such instruments. A group of petitioners, styling themselves "holders of the Bonds of the Spanish government" undertook to interfere with the attempt. Spain being a defaulter on its external debt since 1824 they stated that, if the committee were to sanction the introduction of the new instrument in the market, this would create "a system of credit most injurious and destructive to [their] interests."[20] What is more, they sought to elevate the dispute. They wanted a new law to be adopted by the stock exchange committee, and which would apply not just to Spain but also to every defaulter present and future. Since the chairman of the committee was one of the petitioners, they swiftly secured both the interdiction and the new rule.[21]

Technically, the statute provided, first, that the committee would not allow new loans to defaulters in the market. The language used indicated that "bargains" (that is, trades) involving such forbidden instruments would not be "sanctioned or taken cognizance of". This meant that they would fall outside of the jurisdictional purview of the committee – in essence they might exist but as outlaws. Additionally, the statute indicated that such new loans might nonetheless be admitted but only if the defaulter had offered a "satisfactory arrangement" to creditors.[22]

The modern economic history literature, which has learned about the veto from faulty second or third hand accounts, has described the rule as a kind of listing requirement operated by a bureaucratic agency (the London stock exchange) which when checking the admissibility of a new loan, examined the track record (See Eichengreen and Portes 1989, p. 15-16 and Eichengreen (1991 pp. 162–3 for characteristic accounts). In these readings, which were heavily influenced by the contemporary game theoretic literature on sovereign debt, the statute amounted to a technology to punish defaulters who were to be excluded from the market and subjected to the resulting stigma. For instance, Mauro and Yafeh (2003, p. 22) state that the main "method for punishing defaulting countries was to attempt to block them from obtaining new credit. Formally, this method relied on the London Stock Exchange, which […] would refuse quotation to new bonds to be issued by governments that were in default on existing obligations and had refused to negotiate in good faith with their creditors."[23]

But this is a very incomplete reading of the statute. First, I argue that the statute of 1827 upheld creditor hierarchies. The committee was not a regulatory agency but a tribunal that enforced rights. In particular it ensured that the rights of holders of London issued sovereign debts ranked equal to one another and enjoyed absolute seniority over later London creditors. To understand why, we need to take a more careful look at the manner in which the veto did interact with the manner in which the stock exchange returned the law. In essence, the rule gave grounds to creditors inside the "club" defined by their holding of the defaulted bonds of a given country to file a complaint against a new loan. Upon hearing that an underwriter was applying to get a new loan to a defaulter admitted in the market, it was competent for such creditors to invoke the statute and request the exclusion of the loan.

As a result, outside lenders were prevented from merging with club-creditors, whose rights they would have diluted. But this logic also applied to insiders. The statute ensured that it would not be possible for some creditors to exploit others in return for preferential treatment. This meant that no sub-group of creditors could "sell" to a defaulter restored market access. Since the committee would not consider this as an acceptable arrangement, it would not pay for defaulters and their financial agents to try and buy out some creditors. The end result was that club-creditors thus defined were protected against competition from both within and without.

Now of course, it was always possible, at least theoretically, for a borrower to move to another market. In the early period we are dealing with this e meant issuing the loans through brokers prepared to defy the interdict of the market. Such transactions were formally possible, with the provision that in case of a dispute the brokers would not be able to turn to the stock exchange committee. All they would be able to do would be try and rely on the law of the land and regular courts of justice, which were much slower and in many cases did not recognize the transactions that were routinely performed on the stock exchange. There was a much more serious danger, however. Doing so exposed the breakaway lender to exploitation by rogue borrowers. Lenders in that hypothetical secession loan would be vulnerable to a modified form of the sovereign debt puzzle: Why repay one's debt to a junior creditor when this entails no benefit since it does not control market access? This outcome is a sovereign debt analogue to Avner Greif's 14suggestion that coalitions are supported by "cheat the cheater" strategies – individuals who break rules expose themselves to being cheated by third parties (Greif 1993).

An example (to which I will I return in detail in a later section) will serve to illustrate this crucial point. In January 1831 an attempt was made by a banker to issue a new Portuguese loan in the London stock exchange.[24] But the country was in default leading holders of Portugal's unpaid London debt to litigate the loan. They secured its exclusion from the stock exchange committee. Nevertheless, the banker decided to move the issue to the informal market.[25] Acknowledging that the ruling had an adverse effect on the issue in a language that appears to have recognized foregone liquidity as a main penalty, he cut the price down by 6%.[26] At that point however, the subscribers whom he had canvassed jumped ship. Five only stayed aboard, subscribing a tiny fraction (10%) of the loan and they forfeited subsequent installments. The loan failed abjectly.[27] The episode can be illustrated in terms of the "cheat the cheater" logic I have expounded. When they learned about the decision of the stock exchange to exclude the new loan, potential subscribers realized they would not be pooled with previous creditors in future negotiations. Each of the five holders would have to deal bilaterally with the borrower and they did not like the sound of it.[28]

Another crucial consequence of the statute of 1827 is that it created incentives for undertaking the origination of sovereign debt restructurings. One convenient way to see this is to think in terms of "Coasian bargaining." In the classic example of the neighboring farmer and cattle-raiser, legal liability of the cattle-raiser for damage to crops creates incentives to strike a mutually advantageous bargain. For instance, the cattle-raiser subsidizes the farmer for not cultivating the land if the liability cost from damage to crop is larger than the net revenue from cultivation (Coase 1960). In essence, the statute of 1827 produced a similar set-up by creating a "liability" for underwriters. Unlike the farmer in the classic example, underwriters were not financially liable to creditors but just like the farmer who can be penalized for the externality he creates, they could use the stock exchange committee to go after an underwriter (as in the example above). This created an incentive for the two parties to strike a deal: Loan originators (underwriters) would only originate loans that would buy-out creditors. To put it in another way, feasible loans were essentially sovereign debt restructurings. They involved a debt arrangement and an injection of cash.[29]

One important function of the committee was to uphold the contestability of the market for sovereign debt arrangements. Competition among sovereign debt restructuring originators secured this outcome. In other words, while the stock exchange committee upheld cartel behavior *among creditors*, the sovereign debt arrangements were competitive. From this vantage point bondholder assemblies performed a vital function in enabling creditors to assess alternatives. They may be thought of as serving to auction out debt arrangements. This ensured that the best available debt restructuring would be offered to bondholders.

In fact, the statute of 1827 contained much more than meets the eye. As Olson argued a public good can be managed by the emergence of a club and the creation of specific privileges accruing to club members only (Olson 1965). The statute should be read as one element inside an array of legal services which the stock exchange committee provided investors with. This meant anything but applying the statute by rote. Responding to a challenge by one dissentient broker who believed that the statute of 1827 was just what it said, an angry chairman of the stock exchange committee declared that "the discretionary power of the [stock exchange] committee were very extensive and they would exercise them in cases where no definite rule existed in the book of regulations whenever they saw fit to do so."[30]

This proactive attitude led to a gradual expansion of the remit of the statute. For instance, other forms of default than debt repudiation or interest in arrears, such as failure to provide for amortization, came to be recognized as default. In cases, a whole new statute could be created. For instance, during the shadow-banking boom of the 1860s, an attempt at launching an investment trust that would make new loans to defaulters was met by the creation of a rule that would delist the delinquent institution. The logic was that such instruments, by pooling creditors together, would have greater bargaining power and could dilute the rights of previous creditors.[31]

Beyond this, it must be understood that the statute of 1827 did signal the determination of the committee to lend its authority at large to efforts made to provide solutions to the wave of defaults that had decimated the foreign stock market. As a result, it was prepared to enforce all kind of relevant contractual provisions that promoted the interest of creditor clubs. This phenomenon was not captured in statutes and as a result, it left no trace inside the *Rules and Regulations* of the London Stock Exchange.

Crucially, as I found, the committee was prepared to enforce contractual clauses that secured creditor control over defaulters as debt restructuring workouts unfolded. To be credible, sovereign debt restructuring originations required ensuring that creditor cartel behavior would be upheld, not merely until a debt arrangement was concluded and a new loan was made, but beyond this point, until the credit of the borrower was reconstructed, pretty much as happens today with an IMF loan.

In other words, the committee supported the design and implementation, through contractual clauses it enforced, of sophisticate conditionality arrangements. To secure this outcome, the committee was prepared to recognize contracts that stated such things as preventing new lenders from luring away a defaulter who was on the path to recovery. In an example that will be discussed in detail in the case study I in Section IV, a clause in the debt restructuring arrangement provided that if a competing loan emerged, its maker would still have to secure the support of previous creditors. By recognizing such a clause, the committee enabled creditors to keep the defaulter on a tight leash (the exact opposite of what is assumed in the free riding view). The upshot is that it enhanced the credibility of sovereign debt restructuring exercises.

The greater organizational capacity, which the law of the stock exchange committee imparted to the creditors of sovereign defaulters had wide ranging consequences on the ability to conduct successful debt reorganizations. In particular this exercised powerful traction on borrowers with low or no credit (as defaulting governments tend to be by definition). The ability in which creditors found themselves to rely on the stock exchange to get organized and design complex conditionality structures served as a signaling mechanism and could pave the way to the establishment or restoration of creditworthiness. The ability of the stock exchange to coordinate creditors and implement complex conditionality structures in return for the injection of new cash enabled to distill credibility out of thin air.

But there was another mechanism, which gave enormous political power to the stock exchange committee. The creation of creditor coalitions made it easier for bondholders to internalize the costs of modifying the preferences of the country under consideration. This can be understood as the 19th century distressed sovereign debt equivalent to modern corporate distressed for control. Consider a given debt-restructuring plan. The question at hand is, can it be forced upon the defaulter? The theoretical point is that cooperation of the defaulter can be considered as a transaction cost. The underlying calculus that governs a coalition's ability to press a debt restructuring onto a defaulter boils down to comparing the expected cost from inducing the desired policy change with the expected gains. Calling θ the political transaction cost, P_d the price of the debt in distress and P_r the price of the debt after a restructuring and assuming for simplicity that there is one unit of capital to be restructured, the condition for a vulture investors' raid is (E the expectation operator): [32]

$$E\{P_r\} - P_d \geq E\{\theta\}.$$

The result is that creditors found themselves in the position of implementing what I suggest to call "Vulture Diplomacy". Such interventions could take a "soft" form, for instance through the purchase of votes in Parliament or the bribing of foreign leaders. Because loan negotiators were privy to arrangements, they could trade on private information, which means that they could capture some of the profits accruing to a given debt restructuring. Creditors could help boost the profits of these political intermediaries by lending them the funds that enabled the speculation. This was not merely a theoretical possibility. Walton (1829, p. 180) describes it as "diplomatic stockjobbing." Mathew (1970) provides the example of a successful debt arrangement in 1848 facilitated by creditors inviting the Peruvian debt negotiator to join an insider-trading scheme.[33] Alternatively, hostile policy makers could be removed forcefully: In the example discussed further below, debt restructuring originators exploited a succession crisis in a defaulting country to get rid of the incumbent leader and replace him by an outside politician, whom they controlled through a nexus of contracts enforced by the stock exchange committee.[34]

Section III. Sovereign Default Entrepreneurship

An important consequence of the availability of the law of the stock exchange was the creation of large coalitions that were capable to design, negotiate and implement sovereign debt restructurings. This is at odds with the emphasis in the conventional literature, which holds that bondholders' ability to project power was severely undermined by transaction costs. For instance, these analyses suggest, who was going to shoulder the non-trivial costs of organizing the bondholders, when all that this could bring to the individuals who would take care of this business was either the cold comfort of penalizing a delinquent state or, in the case a defaulter were to change its mind eventually, benefits that would have to be shared with passive creditors? In the conventional narratives the transaction costs stood in the way of collective action.

But in my alternative analysis, default entrepreneurs emerged and undertook the work of upholding the rights of creditors. In particular, they were glad to perform the organizational, legal, and financial work needed to implement successful debt restructurings, because this was a rewarding work. From a theoretical point of view, the logic behind the emergence of this significant economic activity may be cast in terms of Coase's concept of property right entrepreneurship (Coase 1971). In Coase's analysis of the construction of lighthouses in Britain, the externality inherent in the provision of the public good was addressed by enabling lighthouse entrepreneurs to charge users by levying a fee in ports. In the present case, the stock exchange created the right to implement profitable debt restructurings and the response consisted in wealthy capitalists emerged to take advantage of the right.

In practice, successful origination of sovereign debt restructurings required to perform a succession of distinct tasks. The first was the promotion and control of bondholder protective organizations. This was valuable because it did secure legitimacy when litigating at the stock exchange. For instance, as we have seen, the statute of 1827 stipulated that new loans to defaulters would be rejected unless a "satisfactory arrangement" had been provided. Against this backdrop, leadership of the relevant protective committee enabled default entrepreneurs to document whether or not any given new loan met the legal criterion.

For instance, organizing a bondholder meeting (which was a costly operation of course) was valuable, because it was part of the creation of a "paper trail" that would prove valuable when litigating. Because the stock exchange committee recognized majorities, the results of divisions taken during such gatherings could be handed out as evidence of whether an arrangement was satisfactory or not. This would play a major role in informing the verdict. In other words, if default entrepreneurs did the work well (that is, if bondholders were well organized) they were more likely to sway the decision of the stock exchange committee. In summary the expenditures incurred in organizing the bondholders and running their committees were valuable because they served to reduce uncertainty and secured a greater ability to predict legal outcomes.

What is more, armed with control of the relevant bondholder committee, default entrepreneurs could initiate negotiations with underwriters and defaulters using the credible threat of blocking new loans. Consistently with the concept of Coasian bargaining I have outlined earlier, cooperation between such bondholder entrepreneurs and underwriters was the norm, since no one could afford conflict. As a result, far from being under-funded as previous research has suggested, bondholder organizations were subjected to the devoted love of "vultures".

This explains the emergence of the likes of the wealthy Richard Thornton with whom this paper began. Often, they might have been bondholders themselves to begin with, but seeing an opportunity where other investors saw a risk, they had increased their exposure during the descending phase of the distressed debt cycle. At that point, they undertook to promote or take over creditor committees. For instance, Richard Thornton was the chairman of the Portuguese Committee, which dealt a lethal blow to the Portuguese loan discussed earlier. He also participated to Spanish, Peruvian and Mexican bondholder groups.[35] As the next section will show, after Thornton and his allies in the Portuguese Bondholder Committee had killed the Portuguese loan, they undertook to promote their own sovereign debt restructurings. We'll see that the profits could be staggering. Not only does this help explain Thornton's extraordinary wealth but it also explains their dedication, as Evans noted, to the cause of the bondholders. What were a few hundred pounds in overhead expenses when one had cast one's eyes on huge prizes?[36] One further remark is that, for bondholder leaders there was an advantage in developing a reputation for honest representation. Thornton's thirty-five year involvement in creditor committees is not conceivable if he had not rendered "handsome" services, as Evans put it (Evans 1845, p. 155).

A second center of expertise and default entrepreneurship consisted in the legal-financial expertise that revolved around the stock exchange committee. Although control of creditor groups was evidently enormously valuable, key legal intelligence remained tied to the committee itself, where final decisions were returned. In other words critical legal expertise was associated with committee membership. This gave a decisive edge to the partners of prominent London stock exchange brokerages. Because they typically manned the committee, they were privy to its mode of operation, and thus remained the ultimate insiders of the sovereign debt law.

On the one hand they were in a strong position to produce the law of the stock exchange. We already caught a glimpse of this logic when I discussed the creation of the statute of February 1827. The 38 individuals who petitioned the stock exchange committee for the introduction of the rule to deal with sovereign default were all prominent members of the stock exchange and several overlapped with the membership of the committee, past present or future, directly or through a partner or relative. For instance, Thomas Gibbes, the chairman of the stock exchange committee, was one of the petitioners.[37]

This edge in rule making was naturally compounded by the greater ability, which these individuals enjoyed in predicting verdicts. Insiders knowledgeable of the manner in which the legal machinery of the stock exchange operated could make superior predictions. The resulting advantage was entrenched by the manner in which the committee ruled. Its hearings were not public and its verdicts were dry. If one wanted to understand the logic behind any ruling, one had to be part of the process. As a result of this "Star Chamber" quality, which was repeatedly criticized, only the elite of the stock market had access to the relevant knowledge.

Another benefit from this position was that they could reverse engineer the law of the stock exchange and help design clauses, which the committee would likely enforce. What is more, their insider status gave them the means to test the water since they had first hand access to the "judges" who were themselves or their colleagues. They could also lobby peers, increasing the confidence they would have in the performance of a given contract.

Evidence demonstrating the importance of such tactics does fly in the face of any researcher who delves through the minutes of the stock exchange committee and matches the formal legal process with biographical data to catch a glimpse of this behind the scene. Personal or business connections were routinely mobilized to persuade the committee of the value of such or such proposition.

In the next sections the distressed debt activities of Jacob "Jack" Ricardo (1780-1834), senior partner of J. & S. Ricardo, a prominent brokerage house, will retain our interest. This brother of the famous economist was an insider of the committee, of which he had first been a member in 1815 and a chairman in 1820.[38] Jack was highly involved in Spanish, Greek and Portuguese defaulted debts. Jack became a key agent in the successful Portuguese debt restructuring operation of 1831, which will be examined in detail in the next section. The point is not that stock exchange insiders would bend the law. They had a much better time exploiting it. I will return to this important point later in the paper.

The third source of relevant knowledge I consider is political expertise. For a sovereign debt restructuring origination to be successful, the cartelization of previous bondholders and the preparedness of the stock exchange committee to enforce complex contracts had to be matched with the country's willingness to engage. This required a specific expertise, which neither the activist bondholders nor stock exchange brokers had to begin with, though they worked to accumulate it.[39] The result was the intervention of foreign political entrepreneurs. The economic logic behind their involvement stemmed from the value they created through their ability to read the country. They were experts in pricing political transaction costs (who to buy out, how, and at what price) and this found its place in the distressed debt food chain.

One such individual to whom we will return soon was Juan Álvarez Mendizábal, a Spanish venture capitalist who was involved in the showdown between absolutists and liberals that dominated politics in the Iberian Peninsula during the 1820s.[40] Mendizábal had supported the Spanish Revolution as financier of the Liberal "Cortes" in the early 1820s, but the Cortes regime had been toppled when a French army had restored the absolute rule of Ferdinand VII and Ferdinand repudiated the Cortes debts, providing the prelude to the creation of the statute against defaulters in 1827. He was looking for a job when he suddenly barged into the Portuguese affair, which the next section will describe.

To conclude, as it has probably already appeared to the reader from the previous examples, a fair amount of overlap existed across the three groups of sovereign debt restructuring originators. The separate identification of the vultures leading bondholder committees, of the elite brokers controlling the tribunal of the stock exchange, and of the political entrepreneurs figuring out how to modify a country's agenda, is useful because indeed these corresponded to different area of expertise. At the end of the day, however cooperation and overlap was in the essence. Distressed debt investors and prominent brokers overlapped because both were important sovereign debt investors and because they needed one another. As for foreign political entrepreneurs, they were wealthy financiers who invested in international markets, which means that they were directly interested in distressed debt. If they could figure out the politics, the stock exchange would figure out the financial engineering. In the end, the bondholders were not at all the helpless, disorganized bunch of the conventional accounts. They enjoyed support from a tremendously powerful and closely-knit clique, which the stock exchange committee, that great aggregator of information, interests and opportunities, kept together.

Section IV. Loan-To-Own in Practice

In the Portuguese example I now explore in greater detail as a characteristic instance of such raids, defaulted bonds played the role of the fulcrum security, in that they enabled to activate a legal mechanism that resulted in the eviction of an incumbent manager seen as hostile and his replacement by a cooperative one. I show how this was done and demonstrate that state sovereignty was within the reach of the law of the stock exchange.

The Portuguese situation arose as a result of the confrontation between the "absolutist" and "liberal" factions, which dominated politics in the Iberian Peninsula during the 1820s and beyond. It erupted following a coup performed in 1828, with the support of the King of Spain, by Dom Miguel leader of the absolutist faction and the younger son of the deceased King of Portugal Joao VI. Reneging on an agreement brokered by his brother Dom Pedro protector of the liberal faction and the Emperor of Brazil, Miguel rejected the constitution and proclaimed himself King of Portugal. Severe repression against liberals ensued, leading to the escape of liberal forces to the tiny Island of Terceira in the Azores, where an insurgent government known as the "Terceira Regency" was eventually created. The Regency, which enjoyed the support of Dom Pedro, upheld what it proclaimed was the legitimate government of Portugal of which the Infant Dona Maria, daughter of Dom Pedro, was Queen.

The element that was to decide of Miguel's ultimate fate was his decision to follow Ferdinand's example and default on Portugal's London debt, issued in 1823. As a result of the Treaty of Separation of 1825 between Portugal and Brazil, which had established Brazil as an independent country, Brazil was committed to an indemnity towards Portugal, part of which being paid by Brazil's servicing of Portugal's loan 1823.[41] But following Miguel's coup however, Pedro instructed his London agents to dispatch the Brazilian funds to the Terceira Regency, the legitimate ruler of Portugal in his eyes. As the money was needed to bankroll the fledgling regime, the Regency did not send "a single penny" to the bondholders (as they later put it bitterly). This resulted in the Portuguese loan of 1823 missing the coupon payment of June 1, 1828.[42] Given the political backdrop, Miguel was unwilling to bail out Brazil. It was better to let Pedro grapple with the mess.[43]

This decision opened with the bondholders a rift that led to Miguel's downfall. It seems that Miguel was counting on recognition of his rule by great powers to eventually compel Brazil to resume the service. But the fact was that this eventually created the basis for an alliance between bondholders and Portuguese liberals. The bondholders search for an entity that would repay them rendered them ready to listen to ambitious projects to topple Miguel. This eventually led them to read Pedro as the way to get their money back. Three years later, when Pedro abdicated the Crown of Brazil to place himself at the helm of a crusade to topple Miguel, he found the bondholders ready to listen and the stock exchange ready to help. The result was a bargain, which Pedro and the bondholders would eventually strike, that consisted in providing Pedro with the resources to pay his mercenaries, in return for his promise to indemnify the bondholders. From a financial point of view, the condition for such a trade to be viable was that the total indebtedness that would result from the operation (including both the cost of the campaign and the indemnification) would not exceed the country's ability to pay.

This bargain was formalized in the contract (in fact two contracts), which Dom Pedro would later acknowledge as the single most important agency in his victory. As he described it, it was a "singular contract in which the success of the enterprise was the only pledge, [his own] signature the only surety."[44] The way he put it hinted at the hand of the Providence but he knew exactly what he was talking about. From the vantage point of the Regency, the great traction of negotiating with the coalition of the creditors of the loan of 1823 was that submitting to the requests of the creditors enabled to substitute for the Regency's missing credit, reputation, track record, or resources. What sort of credit could have a non-recognized government in a minuscule island with no tax base, when all it had to show were vague promises to restore the constitutional rule in Portugal, should it ever manage to topple the defaulting ruler?[45] By contrast, negotiation within the auspicious framework provided by the stock exchange was attractive, because it enabled to structure credible loans, as contemporaries did realize.

This equilibrium was reached after some poking around. Shortly after the default, the London press started reporting on the activities of one Richard Thornton, who had built a position in Portuguese securities in the aftermath of Miguel's coup.[46] In 1829, he banded together with two other individuals, probably proxies, and they engaged in bondholder activism.[47] A memorial they prepared was circulated, pledging to uphold the rights of the bondholders.[48] Now joined by the Mayor of London and a few M.P.s, Thornton secured additional visibility and legitimacy by paying visits to the British Secretary for Foreign Affairs Lord Aberdeen. At that point, Thornton's name was splashed in every journal as the benevolent defender of the holders of the Portuguese loan of 1823.[49] Their initial position was that if Miguel were recognized as the legitimate ruler of Portugal, the Brazilian money would eventually have to come their way.[50] As a result, early bondholder meetings displayed a good show of tory MPs.

For that reason, the Regency ignored the creditors and went for a Whig loan. They came to an agreement with John Maberly, an aggressive Scottish banker who had made his fortune as contractor for the British army during the French wars and was a Whig MP. In December 1830, upon hearing about the loan being finalized, Richard Thornton called a bondholder meeting.[51] Well-attended and described by the press as "numerous", it led to the appointment of a "permanent" Portuguese Bondholder Committee that Thornton chaired. Another significant member of the committee was David Salomons.[52] A few weeks later, the trap was closing on Maberly, Salomons taking care of the litigation before the stock exchange committee.[53] As I have described, this caused an investor run.[54] Maberly's loan had a strong support in the Whig press, which excoriated the stock exchange committee, The *Chronicle* lashed at the "mental stupidity" of the ruling. Without the loan the toppling of Miguel it would enable "not one farthing of dividend will ever be paid".[55]

At this point, Maberly's loan being reduced to "*zero*", Mendizábal entered the dance. [56] He saw the opportunity of helping the Portuguese liberals since he shared with them a common enemy – king of Spain Ferdinand.[57] To show his devotion to the cause, he advanced two frigates of his own money and offered to organize a funding mechanism for the Liberal party's crusade against Miguel. Perhaps briefed by his "friend" Jack Ricardo on the mysteries of the stock exchange, he helped the Regency come to understand that it was not enough to make a solemn pledge to reimburse the bondholders later as they had very little credibility.[58] One had to contract formally for a genuine debt reorganization program that would provide forbearance and new cash at once. As he later declared to justify his strategy, attempts at doing otherwise could only lead to "partial Loans, which are of an injurious effect, difficult to be negotiated from the small number of interests which they combine, and liable, according to circumstances, to occasion delays highly prejudicial, to the service of the State."[59] This strategy could not give the fiscal resilience, which the Regency so badly needed.[60]

In late September 1831, appointed Financial Agent of the Portuguese Government (that is, the insurgent liberal Government) Mendizábal was finalizing with Ricardo and the Regency representatives in London the sophisticate contract, which was to be praised by Pedro as the game changer.[61] I argue that this was because of the conditionality it created. First, it phased out the payments and subjected them to successive landmarks being reached. Investors would have to make a first payment, of 8%, enabling the expedition to sail. A second 5% would be released upon Pedro installing his government on any portion of mainland Portugal. The balance was to be paid when the liberals would control Lisbon at which point the holders of defaulted bonds would be indemnified. The indemnification would be operated directly, from the money received, with Ricardo acting as trustee.[62] Finally, a last clause bound the Regency "as a condition sine qua non" if it entered in any other negotiation, that the bonds should "be provided for".[63]

Two months later, on November 28, 1831, the stock exchange's chairman Gibbes (the same individual as when the statute of 1827 had been adopted) announced to his peers the loan would be examined in the next meeting. To make things clear, he stated that that he could already disclose that the loan "differed very materially" from Maberly's "inasmuch as the interests of the Portuguese bondholder had been properly considered" this time.[64] When the discussion occurred, the motion that the "regulation of 28th February 1827 does not apply to the proposed contract" was proposed David Salomons, the member of Thornton's Portuguese Bondholders Committee who had led the charge against the previous loan.[65] It adds perspective to mention that Jack had been among those who had voted against Maberly's loan, as demanded by Salomons.

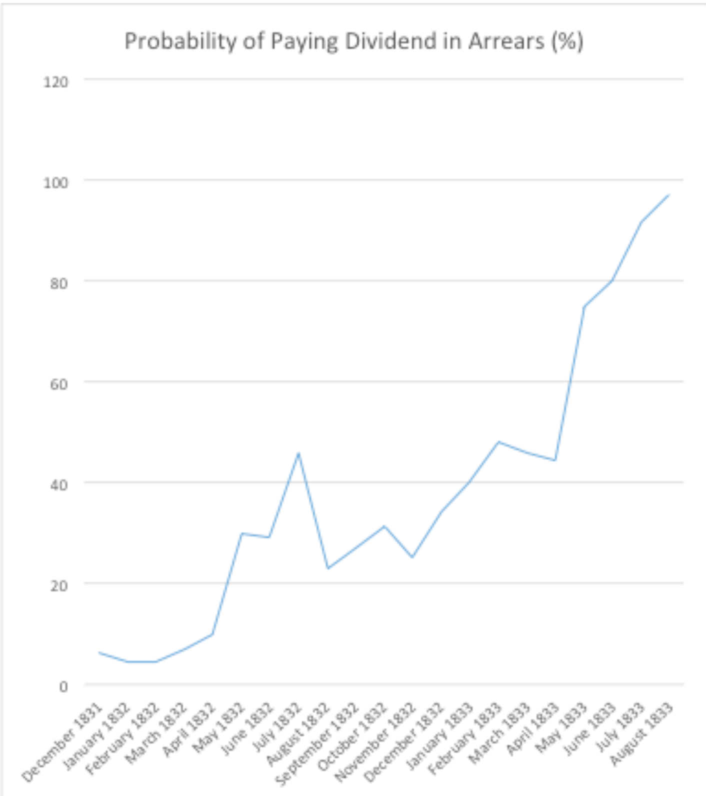
Ostensibly, the contract had been made by a Paris-based international banker, Ardoin, but as Ardoin explained to one of the Regency negotiators, Carvalho, behind Ardoin was really Isaac Lyon Goldsmid a prominent stock exchange member and an investor of bonds of 1823, who was among the first petitioners of the new statute of 1827.[66] As Ardoin explained, Goldsmid had "greater means and more money spent on the funds of the Portuguese loan of 1823, *which he thus wanted to save* [queria salvar]."[67] Other subscribers in the group that took up Ardoin's loan and whose identity Ardoin disclosed (probably because they bought large amounts) included J.&S. Ricardo and Samuel Filipps, an Anglo-Brazilian banker and merchant in Rio and Dom Pedro's "man of business."[68] Thornton later revealed that he had subscribed too. In other words, all the distressed debt entrepreneurs – the vultures, the sophisticate bondholders, the political entrepreneurs and the stock exchange members.

With the spirited clauses, which the stock exchange committee upheld, the arrangement had successfully locked the Regency with this coalition, which Field (1838) describes as the "friends of the cause." Following the Ardoin-Ricardo loan of 1831 and until the victory in 1834, the same group maintained its grip on the finances of Pedro. When in the Summer of 1832, despite the landing in Porto and the release of the second tranche, the house of Carbonell, the treasurer of the Regency in London had to suspend payment and needed to be bailed out the Regency had no other choice than to turn again and again towards the friends of the cause.[69] A second loan was made at a steep interest rate. [70] The creditors' hold had over the Regency was visible in their ability to defeat every attempt to escape it. In January 1833, a loan by Williams, Deacon and Co., was reported to have experienced "sudden death", aided by a "squib" in the Stock Exchange and heavy attacks in the media.[71]

One measure of the credibility of the conditionality regime is provided in Figure 3. Exploiting the fact that the loan of 1823 though identical in all respects to the loan of 1831 embedded a premium for bondholders, it is possible to construct a line that measures the evolution of the probability of repayment (for simplicity I have assumed perfect foresight as if the date of the end of the campaign was known). As we can see, the probability reacted only to political events. The only risk which investors considered were military. This way we see the probability rising in early 1832 and then collapsing on the knowledge that Pedro was encountering military resistance and financial troubles. It rises decisively after victories in the Spring of 1833. Clearly, investors do not seem to have ever questioned the possibility that they would get their money back if Pedro won. They only questioned whether he would win.

At the end of the day, the buy-and-hold investor did just fine. Owing to the modest haircut, the performance realized over the entire cycle (from the issue in 1823 all the way to the unwinding of the trade in 1834) was 5.3% which was quite close to the yield at issue (5.7%). This is for instance much better than the performance that would have been realized by holding risk free consols (3.5%). Of course, as the appendix shows, a "weather vane" investor who would have sold out at the trough in December 1830 would have incurred significant losses. But the point is, that the machinery had worked well. The vultures had arguably performed a useful service to both. They had upheld the value of the portfolio of the buy-and-hold investor and they enabled the "weather vane" investor to walk out.[72]

Figure 3



Source: Author's computations, see text

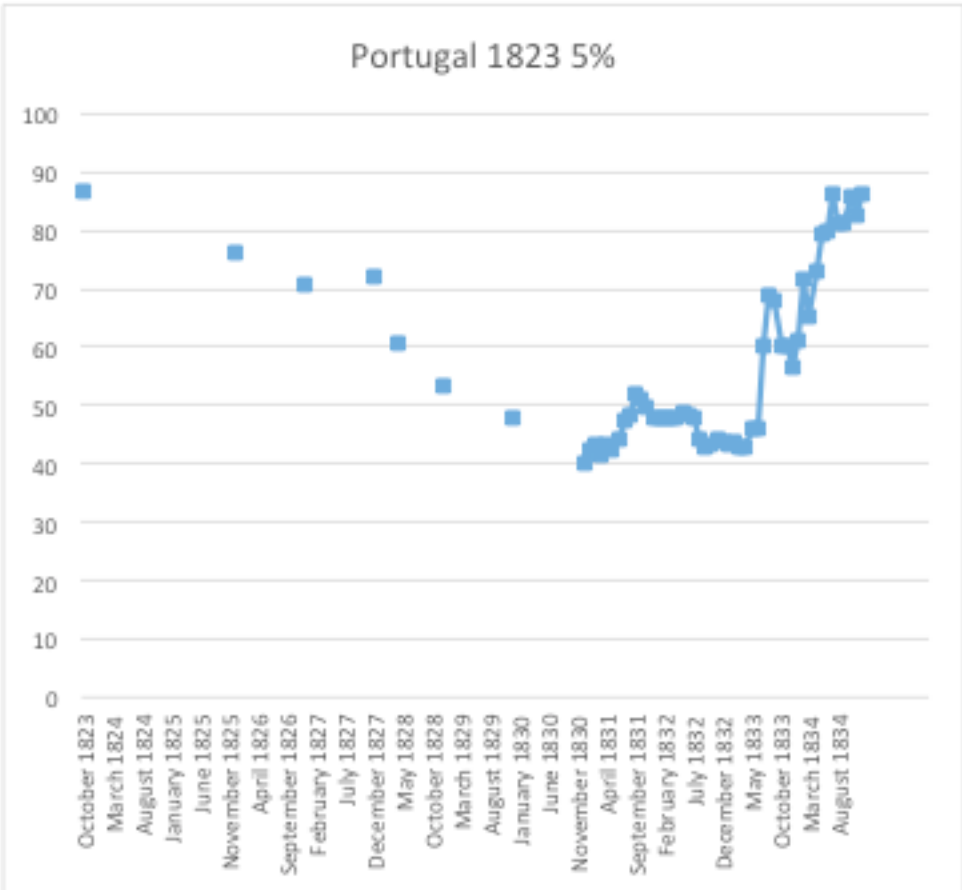
Section V. The Profits from Scavenging

How much money could be made from such trades? This is a critical piece of evidence because distressed debt entrepreneurs' expectations of large profits do rationalize their willingness to foot the bill of bondholder representation. Accordingly, this section discusses the profits earned in the Portuguese trade. One obstacle is the absence of an archive directly documenting the subject. As far as I can tell, no distressed debt investor has left any accounts. As a result, two routes are resorted to. The first is circumstantial evidence that the Portuguese trade brought significant riches to stakeholders. The second is a formal calculation that posits that contemporaries had an understanding of the concept of distressed debt cycle and measures through to peak performance both for aggregate positions and for actual ones documented in contemporary sources. As we will see, the indication point to very substantial gains. This sheds light on the Portuguese vultures' subsequent desire to remain involved in distressed debt operations. In other words, evidence suggests that the Portuguese trade was a foundational episode for the industry at large.

To begin, anecdotal evidence may be resorted to. An intriguing fact that I have come across is that the biographical details of several of the most prominent market operators in the trade contain indications consistent with a significant increase in their wealth precisely at the time when the Portuguese trade was being unwound (1833-34). For instance we are told that in 1833 Richard Thornton became a Donation Governor at Christ Hospital (the charity institution where he had been educated), suggesting that he had done quite well in the preceding years (Howe 2004, quoting Christ Hospital's papers at LMA). Likewise, Goldsmid-Montefiore (1890) tells us that Isaac Lyon Goldsmid helped o establish the University College Hospital in 1834.[73] Another insight is provided by the untimely death of Jack Ricardo in Paris in February 1834 when it emerged that Jack's wealth having increased "recently" by a "great magnitude" he was considering adjusting his will by £50,000. Because he did not have time to do so, in a proper way, a friendly lawsuit had a court dictate the distribution of assets. It seems reasonable to assume that the increased wealth arose from trading profits of J.&S. Ricardo where the two brothers shared control. This means that the gains were upward of £100,000 (since some capital would have arguably been left with the firm). Again, the timing is suggestive.[74]

These appetizers encourage a direct estimate of the gains accruing to investors. Building on the concept of distressed debt cycle, it is possible to calculate the gains accruing to distressed debt investing as the realized return to investors who enter the market at the trough and cash out at the peak. Note that the resulting computation is an upper bound, in that individual traders may have been out of sync. On the other hand, because in the story I tell, distressed debt investors literally drive the recovery of the cycle through their operations, it is likely that they understand well what happened. In a second stage, assumptions regarding the amounts purchased by distressed debt investors, which I derive from contemporary commentary, enable to get a sense of the total gains accruing to speculators.

Figure 4. The Portuguese Distressed Debt Cycle 1823-1834



Source: Author, see Text

The operationalizing of the distressed debt cycle to the Portuguese trade is provided in Figure 2. The figure maps the episode into the distressed debt cycle, identifying key turning points, ignoring for simplicity the various sub-plots that took place during the descending phase. As we explained, Miguel's coup in March 1828 triggered the decline in Portuguese bond prices.[75] The trough is identified as the point where the escalating conflict between Pedro and Miguel led the former to explore ways to remove the latter forcefully. In December 1830, when the contract with Maberly was finalized, Portuguese bonds did reach an all times low of 40. A few months later, the operation launched by Thornton, Ricardo and Mendizabal started to usher in the recovery of Portuguese bond prices.

At the other end of the cycle, we consider two alternatives. The first is provided by December 1833 when the price of Portuguese debt neared 57. This closed a rich year for distressed debt operators the triumphal point being the capture of Lisbon where Pedro and his cabinet could arrive safely on July 28. The event enabled to proclaim the restoration of the rule of the Infant Maria and triggered the release of the balance of the loan of 1831. In turn this paved the way for the indemnification of the bondholders through the agency of J.&S. Ricardo during the fall. In October final details were arranged and announced by Portuguese authorities.[76] In November, an ecstatic Richard Thornton flashed his seal of approval in the press. The policies of the new regime had the "entire approbation" of the Portuguese bondholders, who expressed their "continued confidence in the resources, honor, and integrity of the existing Portuguese Government" etc.[77]

The alternative exit point is December 1834 (Portuguese bonds reached 85). The year had seen the consolidation of Dona Maria's rule. The Civil War had ended with the Concession of Evoramonte of May 26 1834, providing for the exile of Miguel.[78] The international situation was resolved by the Quadripartite Treaty of April 22, 1834, an alliance between Portugal, Spain (now ruled by a liberal party, following the death of Ferdinand) and Don Pedro, backed by Britain and France.[79] Investors regarded the quadruple alliance, which was ratified in London on May 21, 1834 as the signal of the end of the crisis. The day after, the creditors of the Regency "about 150 gentlemen" declaring themselves "friends of Mendizabal" presented him with a "superb silver vase." They were the men behind the Portuguese trade (Richard Thornton, Samson Ricardo etc.) and they were expressing their gratitude with a trophy.[80] In other words my two chosen dates (December 1833 and 1834) book end the completion of the Portuguese trade.

Table 1 gives estimates for the gains realized by what I describe as distressed debt investors according to the two alternative scenarios (trading till December 1833 or December 1834, see appendix for details). Distressed debt investors are defined here as individuals who bought defaulted bonds at the trough and I calculate the gain during the rally. As Table 1 shows, the return from £100 distressed debt investment in December 1830 was about 120% till December 1833 and 200% till December 1834. This corresponds to annualized yields of 21% and 25% per year (see Table 1, £100 investment).[81]

Reckoning that the outstanding amount of the Portuguese debt in default in 1828 stood at £1.3 million nominal capital, the maximum gains that can be realized from this trade, assuming that panicked initial investors sold out to distressed debt investors (a point to which I return in the second section), maximum gains were upward of £600,000 until December 1833 and or upward of one million pounds until December 1834 (Table 1, "Total Profits").[82]

Where did profits realized by actual operators stand? As an illustration, we can plug in the position Thornton disclosed in August 1829, speaking of a £60,000 (nominal capital) holding which we understand was acquired in May 1828 as prices plummeted on speculation on an imminent Portuguese default.[83] Assuming as before that Thornton did ride the recovery until either December 1833 or December 1834, we get a total profit of about 60% or 120% (annualized yields of upward of 8% and 15%). This translates into estimated total profits of about £20,000 and £40,000, respectively (Table 1, "Thornton 1"). These are handsome numbers but most likely a vast under-estimation.

A sophisticate investor, with access to first-hand information, Thornton should have increased his position massively as events unfolded. This is indeed what he later declared having done, revealing during the banquet to honor Mendizabal that his position had been brought to £360,000.[84] As a result, an upper bound for Thornton's realized gains (shown in the table as "Thornton 2") can be calculated by assuming that he increased his holdings when he learned the stock exchange cleared the expedition against Miguel in December 1831.[85] In this case, the estimated total profit is about 80% or 160% (annualized yields upward of 11% and 18%). This translates into estimated profits of about £130,000 and £250,000 respectively (Table 1, "Thornton 2"). The profits

Thornton realized probably stood between "Thornton 1" and "Thornton 2", and probably closer to the later. These enormous numbers shed light on his staggering wealth.

TABLE 1. PROFITS FROM THE PORTUGUESE TRADE: DISTRESSED DEBT

Beginning Trade (date)	End Trade (date)	Investment (£)	Capital Gains (£)	Total Yield (%)	Annualized Yield (%)
100 £.					
12-1830	12-1833	100	117	117%	21%
12-1830	12-1834	100	202	202%	25%
Maximum Profits					
12-1830	12-1833	520,000	611,000	117%	21%
12-1830	12-1834	520,000	1,053,000	202%	25%
"Thornton 1"					
05-1828	12-1833	33,150	19,050	57%	8.5%
05-1828	12-1834	33,150	39,450	119%	15%
"Thornton 2"					
05-1828 & 12-1831	12-1833	160,968	132,675	82%	11.5%
05-1828 & 12-1831	12-1834	160,968	253,575	157%	18.5%

Source: Author's calculations; See text.

Finally, another source of profit consisted in what one may describe as the "venture capitalism" gains. This corresponds to profits realized by the injection of new cash (that is, the Ricardo-Ardoin contract issued in December 1831). As I have explained, such profits accrued essentially to the same group of individuals as the "vulture" investors identified above. The two relevant horizons are the same as before (12-1833 and 12-1834). Table 2 shows under "Vanilla Trade" the total profits accruing to the entire population of investors. For a total investment of £960,000 they were about £570,000 and £1,160,000 or 59% and 121% (annualized yields upward of 20% and 29%).[86]

This is an underestimate of what a sophisticate speculator could have done. Because, as we saw, the contract only required two down payments, one at the launch of the loan and the second when Pedro would have set foot in Portugal, while the balance was paid when Lisbon would be liberated, it effectively enabled investors to leverage the trade. The leverage trade consisted in providing for the first two payments only and selling out on the day of the last capital call. Because the last capital call was conditional upon the liberation of Lisbon and thus upon previous creditors being repaid, our sophisticate trader could focus on the more specifically speculative part of the operation (which required less capital) and sell out just at the liberation. As it required immobilizing less capital for a shorter time, the annualized return for this alternative strategy was also greater. It is shown in Table 2 under "Leveraged Trade". So doing enabled the investor in the Ardoin-Ricardo in December 1831 to walk out 19 month later after Lisbon fell into the hands of Liberals with his initial capital having almost doubled (94% yield, or 51% annualized).

TABLE 2. PROFITS FROM THE PORTUGUESE TRADE: VENTURE CAPITALISM

Begin Trade (date)	End Trade (date)	Investment (£)	Capital Gains (£)	Total Yield (%)	Ann. Yield (%)
"Vanilla" Trade: £100					
12-1831	12-1833	100	45	45%	20%
12-1831	12-1834	100	115	115%	29%
"Vanilla" Trade: Total Profits					
12-1831	12-1833	960,000	412,000	45%	20%
12-1831	12-1834	960,000	1,105,000	115%	29%
Leveraged Trade: £100					
12-1831	7-1833	100	94	94%	51%
Leveraged Trade: Total Profits					
12-1831	7-1833	258,000	242,000	94%	51%

Source: Author's calculations; See text.

Section VI. Looting

According to Holderness and Sheehan (1985) activist investors may be seen as saviors who displace inefficient management, restore financial capability through capital infusion, and create value, but they may also be predators who add leverage, strip core assets and pocket profits while letting other stakeholders hold the bag.

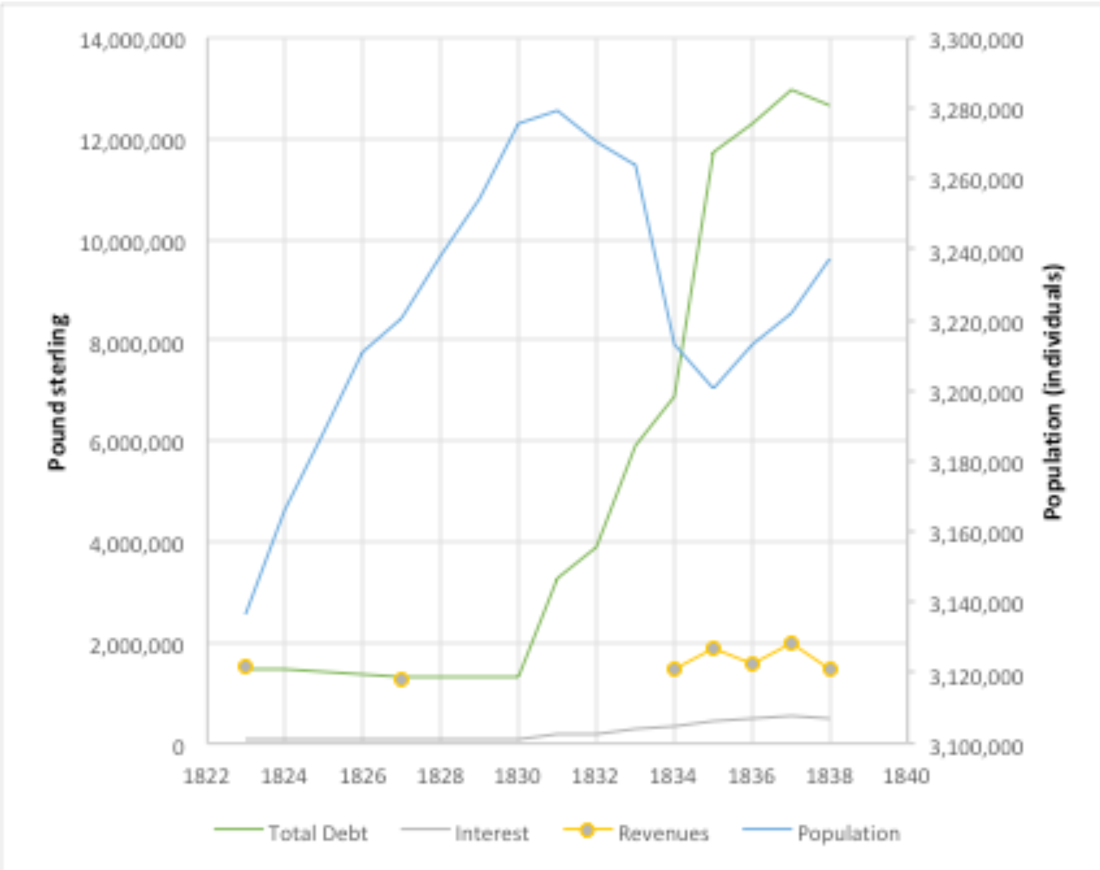
In this section, I show the relevance of this framework to discuss sovereign default in the 19th century. I focus on the Portuguese episode. Indeed, the raid on Portugal rested on a logic whereby the debt incurred to take control of the target and get rid of the current manager (Miguel) would become an obligation of the target once the new manager would have been put in place (Pedro). In other words, this added to the country's obligations. While the outcome, as long as it did not entirely jeopardize the country's ability to service its obligations was favorable to the external creditors against an alternative scenario whereby Miguel rejected paying the obligations, it was less clearly so for "Portugal." In other words, the point is that the alignment between the interests of creditors and that of other stakeholders of the target was imperfect.

Observers soon identified and discussed the diverging incentives. It surfaced in the conversation as it was realized that not everyone in Portugal was happy and welcoming to Pedro. One variant, proposed by the international lawyer John Austin was that it could be that the "besotted" Portuguese people had a right to love and obey their "priest-bestridden government" (Austin 1832, p. 326) and he suggested that this was a right they had. At a deeper level, the war being destructive of resources, it could only be a triumph for foreign creditors. As a contemporary provincial journal summarized, while the Portuguese nation did not show much enthusiasm towards its "savior" Don Pedro whose mercenaries hunted Miguelites down following the capture of Lisbon, the owners of Portuguese bonds felt a "more genuine interest". The journal described sarcastically the bulls and bears in Portuguese debt as "high or low market patriots" and suggested that speculators could "hardly be suspected of insincerity in their profession of anxiety for the establishment of liberal or conservative politics in the Peninsula."[87]

The available data suggests that Portugal took a severe hit at that point (Figure 5). The numbers gathered by Palma, Reis and Zhang (2019) show an excess of death of about 3 percent of the population (roughly 80,000 lives). There is no comprehensive fiscal or debt series for these years (see Cardoso and Lains 2010) but the numbers I have put together from Field (1838) and Pinto

(1839) show that the war itself was enormously expensive. Focusing conservatively on the external debt alone (but domestic sources were also used) limiting the calculation to Dom Pedro's debts (but Miguel also raised debts, that were repudiated by Pedro), Figure 5 shows that the war ushered in a dramatic rise in indebtedness. The ratio of the nominal debt (valued at 5%) to revenues went from 1 in 1830 to almost 5 at the end of the war in 1834. Perhaps a more suggestive measure, as it captures the genuine increase of the debt burden, is the increase of the ratio between revenues and interest service. They jumped from 5% to 25%.[88] The spread between the two, or 20% of revenues, an annual payment of 300,000 pounds is one measure of the looting of the Portuguese economy that resulted from the raid.[89]

Figure 5. The Looting of Portugal



Source: Author, see Text

But it may be that, while there is no offset for the lives irremediably lost, there could have been an offset for the financial costs of the Civil War. In line with modern arguments about constitutions and commitments, one question at hand is whether the regime change that was induced by the transformation produced superior economic results (North and Weingast 1989). The displacement of Miguel, by removing an inefficient regime and brining in new institutions and in particular a constitution and a parliament, might have led to subsequent growth.

This is certainly not an anachronistic question to ask. In conventional accounts, the Portuguese Civil war was a holy war conducted in the name of constitutions, commitments and progress. In fact a prominent protagonist in the ideological dispute in Britain, which pitted Whigs against Tories, was the Whig historian and MP James Mackintosh, father the "Whig interpretation of history" more recently rediscovered in North and Weingast analysis of the role of "Constitutions and Commitments" (Fisher 1928, Butterfield 1931). In a famous speech in 1829, Mackintosh excoriated the Portuguese policy of Wellington whom he urged to intervene against Miguel. The speech contained many themes of the constitution and commitments view with which modern readers are familiar. It deplored the commitment problem of kings, who "rarely their own best friends", it praised Pedro as the upholder of Constitutions (he had given one to Brazil) while Miguel was presented as a modern incarnation of King James (Mackintosh 1829). The argument played an important role in shaping subsequent Whig views on the conflict and came handy as Pedro's subsequent abdication as Emperor of Brazil and self-professed willingness to become the benevolent ruler of Portugal brought echoes of William of Orange.[90]

Against the view of a possible constitutional offset, however, I observe that the fiscal outlook did not improve in the aftermath of the Civil War. The ambitious fiscal plans, which as Cardoso and Lains (2010) described had been conceived in the Azores by a prominent reformist, Mouzihno da Silveira, were shelved. As Figure 5 shows, it took several years after the war (until the 1838) to stabilize the finances of the country. After Portugal regained full market access, the new administration struggled to increase taxation and rein in expenditures, and the borrowing spree continued. By 1838, when the external debt finally stabilized because lenders refused to fund any more debt, the ratio of debt to revenues reached 8.5. The total annual increase in interest service stood at 35% of revenues. This meant an additional annual payment of almost half a million pounds compared to a situation where the Civil War would have been avoided and the books would have continued to balance. This huge increase in indebtedness was essentially wasteful in that it did not result from investment in infrastructures.

In the subsequent period, difficulties continued. As Cardoso and Lains argue "the end of the Civil War in 1834 did not put an end to political instability, and a new phase of unsteadiness ensued that created a difficult political environment for economic and financial reform." I argue that the debt build-up of the 1830s played a crucial role in producing this situation. The countryside, on which the constitution had been forced, remained hostile to the regime and resisted tax increases. Tax reforms were difficult to implement. The result was an alternation of violent tax revolts (such as the revolt of Maria da Fonte), dictatorial governments and the threat of a resumption of the Civil War leading to international intervention. Finally, the growth data suggests that the economy remained absolutely stagnant until the mid-century (Palma, Reis and Zhang 2019).

In other words, while there is strong evidence of looting, there is little evidence of a possible offset from Portugal having adopted what Douglass North liked to call the "right institutions". What is more, I suspect that the bondholder raid of 1831 explains a lot of this performance, which previous Portuguese authors have emphasized. The point is not to lay the blame on the new constitution for these results but rather to suggest that one would be hard-pressed to find in the historical evidence offsetting benefits. To summarize, in terms of the debate on "vultures v. saviors", the Portuguese example shows that distressed debt investors won a lot while the target, very little. The angry (Tory) editor of the *Morning Post* who dubbed the whole affair "the *liberal job*, commonly called the Expedition" may not have been so far from the mark.[91]

Conclusion

This paper has articulated the contours of a novel approach to the history of sovereign debt and default. In this brief conclusion, I shall not repeat the principal arguments of the paper. Rather, I would like to emphasize what I think the paper is about/has done. While the conventional view has depicted a world of powerless creditors pitted against rogue states, my alternative account opens the possibility of a different history, so to speak of rogue creditors pitted against powerless states. The fulcrum on which the whole argument pivots is the law of the stock exchange. The possibility to create and govern a community of creditors appears to have cast a long shadow on the history of the international financial system in the 19th century.