Hidden Holdouts: Contract Arbitrageurs and the Pricing of Collective Rights

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Abstract:

Research on the law and economics of contract typically analyzes the explicit pricing of the contract terms in a debt contract by modeling a bilateral debtor-creditor relationship, a framework we call the “classical model.” Under this model, contract terms that affect the debtor’s repayment obligations are reflected in the price the debtor pays. Much of commercial lending, however, occurs in thick markets with standardized multilateral debt instruments. Depending on the degree to which key contract terms implicate collective decision making among dispersed and anonymous creditors, the classical bilateral model of debt contracting can err in its predictions on the pricing of terms. We utilize Venezuela’s 2014-2018 debt crisis as a natural experiment to evaluate the price effects of differences in contract terms in multilateral debt instruments that require collective decision for enforcement. We test the predictions of the classical model against the predictions generated by a “collective action” model and report evidence of the non-pricing of terms consistent with the collective action story. In particular, we provide evidence of a “hidden holdout” strategy that enables the modern activist investor to capture rents without revealing arbitrage activities that enable the market to coordinate on efficient prices for different rights of enforcement.