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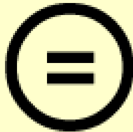
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Opening Pandora's Box:

Relationship between Sovereign Defaults
and International Investment Protection

2015 8

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ABSTRACT

The relationship between international investment law and sovereign debt restructuring is complex and controversial. There are numerous countries that face a risk of a debt crisis, and at some point in the future defaults will certainly occur. It is, therefore, important to ensure that investment treaties and international investment law itself do not prevent nations from conducting debt restructurings in a manner that facilitates economic recovery and development. International tribunals which find that v j g { " j c x g " l w t k u f k e v k q p " g x g p " k p " v j g " R c p f T q e n y f q w v d q " z ö 0 create a window for professional vulture funds to initiate legal proceedings against defaulting sovereign, undermine the ability of nations to recover from financial crises and broaden the impact of such crises, not only for particular state, but for the world economy as a whole.

A statutory sovereign bankruptcy regime under international law has been periodically debated, but so far rejected. In these circumstances states can rely on the contractual approach to the development of debt restructuring protection. Sovereigns should be careful when negotiating their investment treaties and bond contracts and attentive to the wording of each provision. This paper focuses on the clauses, which would grant nations the space to conduct effective sovereign debt restructurings.

Key words: sovereign debt restructuring (SDR), international investment law, bilateral investment treaty (BIT), ICSID, holdout creditors

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ABBREVIATIONS AND ACRONYMS

BIT	Bilateral Investment Treaty
CAC	Collective action clause
CIGI	Centre for International Governance Innovation
CPD	Cumulative probability of default
ECOFIN	The Economic and Financial Affairs Council
ESM	European Stability Mechanism
EU	European Union
FSIA	Foreign Sovereign Immunities Act
GDP	Gross Domestic Product
ICSID	International Centre for Settlement of Investment Disputes
IMF	International Monetary Fund
ISDS	Investor-state dispute settlement
NAFTA	North America Free Trade Agreement
OECD	Organization for Economic Co-operation and Development
PCA	Permanent Court of Justice
UNCTAD	United Nations Conference on Trade and Development

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CHAPTER I: INTRODUCTION

1.1. Purpose and Scope of Study

Given the growing number of legal disputes concerning sovereign debt and many related policy initiatives both on national and international levels, it is surprising that there is only little empirical research on sovereign debt restructuring, holdouts and related disputes. There has been quite an amount of legal research on the purpose of investment protection, scope of investment treaties and implications of dispute decisions by relevant national courts or international arbitration. One can also find economic analyses on the sovereign crisis along with results and costs of past restructurings. However, there still is a lack of sufficient research that provides a comprehensive approach from both the legal and the economic perspectives. Much of the debate keeps referring only to the investors' protection, while a balanced picture including the negative impact of holdouts on the restructuring process and thus on the economy of defaulting state has been missing and no institution has been responsible for collecting representative data.

In this light, the goal of this paper is to build on the existing studies in order to provide a new empirical basis for research on the legal framework of sovereign debt and its potential restructuring. It focuses on the one of the most controversial aspects of international investment law, namely, the relations between sovereign debt restructuring and international investment protection. It is an area that requires considerable

clarification. Moreover, it becomes increasingly important as investors continue to launch holdouts' claims under numerous BITs and investment chapters of trade agreements.

This paper includes five chapters that treat distinct but interrelated issues. Chapter II provides a brief overview on global sovereign debt, possibilities of default and study of the past debt restructurings. The purpose is to introduce the relationship between sovereign debt restructuring and state's economic situation, as well as to show the importance of the research in modern era with a lot of states being only in one step from sovereign default.

In Chapter III, this paper will review the relationship between sovereign debt, bilateral investment agreements and Convention on the settlement of investment disputes between states and nationals of other states. This section of the paper examines the global BIT regime and differences in the definition of "investment" in each and every treaty. Significant inconsistency is found with respect to the coverage of sovereign debt in various trade and investment agreements. Thus, the scope, coverage and jurisdiction vary widely. This part will further analyze the decisions on jurisdiction in the previous cases related to debt instruments and will be concluded by the overview of ICSID arbitration over debt instruments and related jurisdictional matters.

Chapter IV begins with a review of international arbitration concerning debt instruments, presenting the unprecedented Abaclat and Others v. Argentine Republic (2011) case and other relevant disputes, and sovereign debt litigation under U.S. law. It further provides a survey on the positive and negative implications of investment

disputes over sovereign debt restructuring, such as limitation of the “opportunistic defaults” on one side and vulture funds profiting from crisis on the other.

Chapter V proposes several clauses which can prevent frivolous claims over sovereign debt restructuring based on the above legal and economic analyses of the results of previous disputes between defaulting states and holdout creditors. The risk of holdout litigation largely depends on how investment agreements (mainly BITs) and particular debt contracts (bonds) are written. The development of a legal framework prevent frivolous claims can be better achieved by inclusion of collective action clauses into sovereign bonds (which is already done by EU-members in a legislative manner), and paying greater attention to the choice of law and forum. As to the bilateral investment agreements, more cautious approach is required for drafting of the definitions (investment, territorial nexus etc.) and umbrella clauses. Finally, Chapter VI discusses the results of this paper, the remaining agenda for further research, and concludes.

1.2. Research Methods and Sources

The long history of sovereign debt, associated restructuring problems and the recent rise of holdouts’ claims have attracted researchers in different fields. This paper surveys work by economists, lawyers and political scientists. Several methods of research have been used, including literature review, treaty interpretation, and case analysis, based on legal and economic methods.

The empirical literature on sovereign debt restructuring as well as on international investment protection has grown considerably over the last decades, after Argentina's famous debt restructuring in the beginning of 2000th and Global financial crisis, which triggered debt unsustainability in Greece and change in EU legislation related to sovereign bonds. A number of authors have carried out extensive case study research. Primary sources for literature review include academic literature written by legal and economic scholars related to the subject of sovereign debt and restructuring (Das, Eichengreen, Reinhart, Rogoff etc.), books written by prominent investment law specialists (Schreuer, Douglas, Waibel etc.) and IMF, UNCTAD and CIGI documents, including adopted reports, submitted proposals and working papers that highlight the crucial role of government behavior in and before debt crises from a policymaking perspective and provide the quarterly report regarding the reforms of international investment regimes.

The most used sources of public debt data and restructuring history are the International Financial Statistics and Government Finance Statistics databases published by the IMF; and the Global Development Finance dataset of the World Bank, and reports by the Organization for Economic Cooperation and Development (OECD). Statistical data provided by the UNCTAD investment policy hub website and other international investment law-related portals, in addition to information from existing academic literature on the related subject, were gathered to examine the current status of BIT regime, international investment policies and issues.

Analysis of relevant ICSID dispute cases and U.S. litigation also contributed to identifying the issues that are persistent and remain unresolved in the area of sovereign debt restructuring and holdout claims. For the case analysis, primary sources of information are available tribunals' decisions on jurisdiction and merits which can be found on ICSID, PCA and related websites. In addition, existing academic literature assessing the tribunal decisions and results from both legal and economic perspectives also served as reference points.

CHAPTER II: OVERVIEW OF SOVEREIGN DEBT AND RESTRUCTURING

Sovereign debt, especially in the form of government bonds, is an important way for many states to enhance their economic growth. If appropriately managed, government borrowing can be an essential ingredient for economic development. However, when a state has insufficient assets to serve its debt, a sovereign debt default or restructuring will occur.

This section of the paper provides a brief overview on global sovereign debt, possibilities of default and study of the past debt restructurings. The purpose is to introduce the relationship between sovereign debt restructuring and state's economic situation, as well as to show the importance of the research in modern era with a lot of states being only in one step from sovereign default.

2.1. Sovereign Debt: Facts and Data

Despite the fact that the term sovereign debt is frequently used, it spans different concepts with different nuances. There are several meaningful ways of definition and measurement. In this paper, sovereign debt (often referred to as government debt or public debt) is defined as the sum of all financial liabilities of general government and public sector agencies typically in the form of government bills

and bonds.[1] Debt may be owed to foreign or domestic creditors and in the state's own or foreign currency. It is one of the most frequently used concepts in the economic debate: countries are compared and ranked according to the sustainability of their public finances; investors are monitoring the default risks on sovereign debt; public debt management offices are actively trying to reduce those risks etc. As a result, sovereign debt, as an indicator of government activity, is receiving more prominence in both national and international fiscal frameworks.

High level of indebtedness in developed countries is not a new phenomenon and the magnitude of the overall debt problem facing advanced economies today is difficult to overstate. Current global sovereign debt, according to the Global Debt Clock of Economist Intelligence Unit, is over USD 56 trillion.[2]

This burden has been significantly compounded by huge increases in sovereign debt in the wake of the global financial crisis. Figure 1 shows a comparison of the Great Depression (1929–32) with the period marked by the global financial crisis in terms of gross government debt as a percentage of GDP for selected economies. The comparison of two heat maps indicates that the implications of the recent financial crisis for public debt appear to be graver, in spite of a less dramatic growth impact at present as compared with the Great Depression. Debt ratios were on average 20% of GDP higher

[1] OECD Glossary of Statistical Terms, http://stats.oecd.org/glossary (accessed May 3, 2015); EOROSTAT Statististics explained, http://ec.europa.eu/eurostat/statistics-explained/index.php/Main_Page (accessed May 3, 2016).

[2] Global Debt Clock, http://www.economist.com/content/global_debt_clock (accessed May 3, 2015).

(PPP-weighted), in advanced G-20 countries[3] in 2007, right before the crisis, than in 1928. United States, Japan, France and Italy even reached the level of sovereign debt over 75% GDP.

According to the OECD, the situation after the crisis became even worse. Government debt-to-GDP ratios have increased sharply, with the level of indebtedness for some selected advanced economies overcoming the previous historical peak, which was in 1945, the end of World War II (Figure 2). The level of gross sovereign debt continues to grow steadily year by year. If before the crisis in 2007 the ratio to GDP for G7 countries was 85.2%, after the crisis it became 104.9% and reached the unbelievable figure of 125.9% in 2014. For G20 states the numbers are just a little bit lower – 77.3% in 1007, 93.4% in 2009 and 112.2% in 2014 (Figure 3), still being extremely high.

There are a number of different forms of debt financing available to a state seeking to raise funds, from issuing bonds to taking out loans from private banks or multilateral official creditors like IMF. This paper will mainly concentrate on the issues related to sovereign bonds, so called sovereign marketable debt.

Government bonds are its documentary promise to repay borrowed money with interest at a rate determined at issue starting on a date fixed at the time of issue.[4] Sovereign bonds are issued or guaranteed by the state or its central bank. International lending through bonds was prominent in the late 19th and early 20th centuries, but in the 60s - 80s private credit flows took place mainly through banks loans. Lending via bond

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[3] The G-20 advanced countries are Australia, Canada, France, Germany, Italy, Japan, Korea, the United Kingdom, and the United States.
[4] International Monetary Fund, *International Financial Statistics Yearbook*, IMF, Washington D.C, 2000, Introduction, p. xvii.

markets was only about 10% of loan lending in the 70s and early 80s.[5] The situation has changed again after the debt crises of the 80s in Latina America. Additionally, catalyzing private capital flows to emerging markets has been an objective of the International Monetary Fund since the early 1990s.[6] Between 1991 and 2002, lending via bank loans and bonds was of about the same order of magnitude, just under USD 700 billion through each channel.[7]

Although there is no single or complete source for data on outstanding international sovereign bonds and their breakdown as to jurisdiction of issuance, IMF estimates that the value of the current stock of international sovereign bonds outstanding is approximately USD 900 billion.[8] The ratio of sovereign debt in the form of bonds is rising similarly to the level of gross indebtedness. Figure 4 illustrates that the level of government marketable debt before the global financial crisis was 58.5% of GDP for G7 countries and 89.6% in 2014, thus, on average, rising at 4% annually. As for the developing countries, the combined stock of external debt was $5.5 trillion at end 2013 with private creditors accounting for 95% of net long-term external debt flows, divided almost equally between bonds and banks.[9] Figure 5 shows the net debt flow to

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[5] Sebastian Edwards. "The Pricing of Bonds and Bank Loans in International Markets: An Empirical Analysis of Developing Countries' Foreign Borrowing". *European Economic Review* 30 (3) (1986), pp. 565-589.

[6] International Monetary Fund, *Involving the Private Sector in Forestalling and Resolving Financial Crises.* IMF, Washington D.C., 1999.

[7] Barry Eichengreen, Kenneth Kletzer and Ashoka Mody. The IMF in a World of Private Capital Markets. Journal of Banking and Finance, 2006, v30 (5,May), pp. 1335-1357, p.16.

[8] International Monetary Fund, Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring. IMF, Washington D.C., October 2014

[9] World Bank. International Debt Statistics 2015. World Bank, Washington, D.C., 2015

developing countries in 2008-2013, where the rising importance of the sovereign bonds can be seen.

Data on the external debt is an important marker of overall vulnerability, as the boundaries between public and private debt often become blurred in a crisis. External private debt is one of the forms of so-called “hidden debt” that emerge out of the woodwork in a crisis. Just as bank balance sheets before the Global financial crisis did not reflect the true economic risks; official measures of public debt are typically a significant understatement of vulnerability.[10]

As indicated above, when a state has insufficient assets to serve its external debt, a sovereign debt default or restructuring will occur. According to Standard & Poor’s definition, a sovereign debt default is a failure of a sovereign borrower to meet principal or interest payment of its debt obligations on the due date.[11]

Figure 6 provides an overview of total sovereign debt in default for the last two decades, emphasizing the bonded debt in default. One can easily see outliers for bond defaults: in the end of 90s – the 1995 Mexican crisis, Russia’s 1998 default etc.; early 2000s – with a well-known Argentina’s default; and a massive rise of defaulting bonded debt in 2012 suffered mainly by Greece.

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[10] Carmen M. Reinhart and Rogoff, Kenneth. *Financial and Sovereign Debt Crises: Some Lessons Learned and Those Forgotten*. IMF Working Paper (No. WP/13/266), December 2013, p.7

[11] Roger J. Bos, Brady Brooks and Diane Vazza. *Ratings performance 2002: default*, *transition*, *recovery, and spreads*. Standard & Poor's Technical Paper, February 2003

Table 1. Global Rankings by Cumulative Probability of Default exhibits the cumulative probability of default from the Global Sovereign Credit Risk Report,[12] listing the twenty five nations with the highest probability of default as of the end of 2014, as well as the bonded debt of those states and the number of BITs in force. CPD quantifies the probability of a country being unable to honor its debt obligations. Argentina tops the list, already being in a state of "selective default"[13], as rated by Standard & Poor's. Argentina has USD 595.8 billion of outstanding bonds and 66 BITs with other states, which could possibly give ride to the creditors' claims in international arbitration and domestic courts.[14] Venezuela and Ukraine follows, with a 65.8% and 59% chance to default in 2015, additional cumulative USD 76.1 billion of bonded debt and 90 BITs in force. Total amount of outstanding bonds of these top 25 nations with the highest likelihood of default is USD 1.8 trillion, and, on average, each of these states is a signatory to 52 BITs.

As presented above, sovereign defaults occur regularly and often violently. The recent debt crisis in Greece almost led to the collapse of the Euro regime. Many countries, if not today then the next time around, may need to reschedule, restructure, or even default on their debt. Yet there is no legally and politically recognized procedure

[12] S&P Capital IQ. Global Sovereign Credit Risk Report for Q3 2014. McGraw Hill Financial, New York, September 2014

[13] Rated as "SD", meaning that the obligor has selectively defaulted on a specific issue or class of obligations

[14] Following the well-known Abaclat and Others v. Argentine Republic (2011) and Ambiente Ufficio S.p.A. and others v. Argentine Republic (2013) cases under Italy-Argentina BIT in ICSID and NML Capital, Ltd. v. Argentina (2014) case regarding previous default in US court

for restructuring the debt of bankrupt sovereigns. However, there is an agreement that this important issue should be brought to the center of international debate.

2.2. Sovereign Debt Restructuring

C " u q x g t g k i p " f g d v " e t k u k u " k u "
í " K v " f q g u " p q v " j c x g[15]*" v q " d g e q o g*

With the advent of the global financial crisis, the issue of restructuring sovereign debt has become one of the key concerns to governments and market participants. To this date, however, there appears to be limited understanding on how restructurings work in actual practice, while detailed historical insights are often missing. While there is no universally accepted definition, according to the IMF official documents a sovereign debt restructuring can be seen as the mechanism for sovereign debt exchange where sovereign debt bondholders take old bonds for new debt instruments or cash under a formal process.[16] Financial dictionary defines debt restructuring as a modification of the terms of a loan to provide relief to a debtor who could otherwise default on payments. The restructuring may involve extending the period of repayment, reducing the total amount owed, or exchanging a portion of the debt for equity in the debtor company.[17] In a restructuring process creditors accept new contractual terms which are less favorable in order to avoid the risk of non-payment. One can generally distinguish two main elements in a debt restructuring: (i) debt

[15] Lee C. Buchheit & Mitu Gulati, *Walking Back From Cyprus,* Draft Working Paper, 1 (18 March 2013).
[16] Das, Udaibir S., Michael G. Papaioannou, and Christoph Trebesch. *Restructuring Sovereign Debt: Lessons from Recent History*. International Monetary Fund working paper, August 2012.
[17] Financial Dictionary, http://financialdictionary.thefreedictionary.com/Debt+Restructuring (accessed May 5, 2015).

reduction – a reduction of the debt's face (nominal) value; and (ii) debt rescheduling – the lengthening of maturity term of the old debt, sometimes also involving lower interest rate.

Sovereign debt restructuring episodes have been widespread around the world, with more than 600 individual cases in 95 countries during the past 60 years alone.[18] Of these, 187 were debt restructurings with private creditors (foreign banks and bondholders) and more than 450 involved restructurings with the Paris Club (government to government debt).[19] Figure 7. shows the restructuring events with private creditors by states. Of these 187 debt exchanges in between 1970 and 2013 (as of August 2014):

- 22 were sovereign bond restructurings, while 165 affected bank loans;
- only 57 involved a face value reduction, while 129 were purely rescheduling deals (thus, limited to extension of maturities);
- 109 cases occurred post-default, while 77 were preemptive. These include Pakistan's debt rescheduling in 1999, Uruguay's in 2003, Ukraine's debt reduction in 2000 etc.[20]

One can notice that there were only 22 sovereign bonds restructuring events, so why are sovereign bonds so important and framework for their restructuring widely discussed by IMF specialists and government officials? Table 2. Bonded debt

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[18] Juan J. Cruces and Trebesch, Christoph. "Sovereign Defaults: The Price of Haircuts". *American Economic Journal: Macroeconomics,* vol. 5, no. 3 (2013), pp. 85-117.
[19] Ibid. 18, pp. 85-117.
[20] Udaibir S. Das, Michael G. Papaioannou, and Christoph Trebesch. *Sovereign Debt Restructurings 1950 –2010: Literature Survey, Data, and Stylized Facts*. International Monetary Fund working paper (WP/12/203), 1 August 2012.

restructuring between 1970 and 2013 provides the details for bonded debt restructuring deals between 1970 and 2013, but as seen in the second row all 22 events happened in the last 2 decades (zero bond deals since 1970), starting with Panama's bond restructuring in 1994. Number of bond deals grows steadily, with 6 of them (near 25%) happening in 2010-2013. As presented in the previous subparagraph, the level of sovereign debt in the form bonds is rising during the last decades and so does the number of restructuring events.

Among the 22 cases, only 13 bond restructurings involved a face value reduction, while 129 were purely rescheduling deals, thus, limited to extension of maturities (Table 2). Face value reduction, on average, was 28.8%, with the minimum of 0.9% in case of Ukrainian restructuring in 2000, and maximum of 68.6% in case of Ecuador in 2009. The most prominent cases were for sure Argentina's restructuring in 2005 and Greece in 2012. Argentina restructured over USD 60 million of bonded debt, with a face value reduction of 29.4%. Greek restructuring was far more noticeable and involved USD 261.4 million in bonds (Table 2). As will be discussed later in this paper, courts' and tribunals' decisions related to Argentina's bond restructuring are seen as the ones that are "opening Pandora's box".

The key difference between bond and bank debt (loans) restructurings is in the creditor structure, which is more dispersed in the latter case, especially if bonds were sold on secondary market. Indeed, some bond restructurings of recent years, such as the Argentina case, affected thousands of individual creditors, with an estimated 600,000

and 100,000 retail investors, respectively.[21] Such creditor structure makes it difficult to identify and communicate with bondholders, and what is more important to get 100% agreement for restructuring.

According to IMF, the problem of creditor holdouts and related litigation has been widely seen as the main potential obstacle to timely and efficient bond debt restructurings.[22] The number of litigation cases following a default or restructuring on sovereign debt have notably increased. There were more than 100 individual litigation occurrences in the past thirty years[23]. Figure 8 shows that more than half of all cases were initiated in U.S. and UK after 1994 (the first bonded debt restructuring), despite the fact that the number of sovereign defaults and restructurings has gone down in the past decade. The increase in the number of cases in 2005-2007 relates to the dozens of lawsuits following Argentina's default, mentioned above. This fact again underlines the importance of global sovereign bankruptcy system and greater attention to the sovereign bonds contracts as well as the exclusion of "sovereign debt" from the investments covered by the BITs to preclude investment disputes by holdout creditors.

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[21] Ibid. 16.

[22] International Monetary Fund. *A Survey of Experiences with Emerging Market Sovereign Debt Restructurings.* IMF, Washington D.C., June 5, 2012, p.11.

[23] Henrik Enderlein, Julian Schumacher and Christoph Trebesch. *Explaining Creditor Litigation in Sovereign Debt Crises*. Unpublished Paper. Hertie School of Governance. 2011.

CHAPTER III: RELATIONSHIP BETWEEN SOVEREIGN DEBT RESTRUCTURING AND INVESTMENT DISPUTES

To figure out the relationship between sovereign debt restructuring and investment disputes, the jurisdiction of the ICSID and the scope of "investment" under the relevant BITs are two important sources of guidance. In this section, we will examine the global BIT regime and differences in the definition of "investment" in each and every BIT. Significant inconsistency is found regarding the coverage of sovereign debt in various trade and investment agreements. Thus, the scope, coverage and jurisdiction vary widely. This part will further analyze the decisions on jurisdiction in the previous cases related to debt instruments and will be concluded by the overview of ICSID arbitration over debt instruments and related jurisdictional matters.

3.1. Debt Instruments under BITs

3.1.1. Introduction to the BIT regime

Whoever drafted the text of the first bilateral investment treaty could not have possibly imagined how popular this work would become. The extraordinary increase in the number of agreements related to the protection or liberalization of foreign investment is one of the most remarkable phenomena in international law during the past decades.

International agreements relating to investment have a long history. Similar provisions related to the property abroad can be found in agreements dating back to the

late eighteenth century. For example, around that time the United States began to conclude bilateral treaties of "Friendship, Commerce and Navigation", the purpose of which was to establish trade relations. The first such agreement was the Treaty of Amity and Commerce negotiated with France in 1778 by Benjamin Franklin, Arthur Lee, and Silas Dean.[24]

Figure 9 illustrates the trends in international investment agreements signed between 1980 and 2014. The number of BITs prevails, compared to the so-called "other IIAs".[25] And the remarkable increase is seen in the 90s. Today, the total number of agreements is as high as 3,268. This number includes 2,923 BITs as well as nearly 345 other agreements that contain investment provisions.[26] The number of countries that have signed at least one BIT has reached 149, leaving very few countries without such treaties.

The year 2014 saw the conclusion of 27 new investment agreements, which is one every other week.[27] Particularly, 14 new BITs and 13 "other IIAs" were signed (Figure 9). Countries/economies that were particularly active in concluding investment agreements in 2014 include Canada (7), Colombia, Côte d'Ivoire, and the European Union (3 deals each).

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[24] Karl P. Sauvant and Sachs, Lisa. *The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows.* Oxford: Oxford University Press, 2009, p.4.

[25] "Other IIAs" refers to economic agreements other than BITs that include investment-related provisions (for example, investment chapters in economic partnership agreements and FTAs.

[26] UNCTAD. *Recent Trends in IIAs and ISDS*. IIA issue note. #1. United Nations, Geneva, February 2015, pp.1-2.

[27] Ibid. 26, pp.1-2.

In 2014, several BITs were terminated.[28] South Africa, for example, gave notice of the termination of its BITs with Germany, the Netherlands, Spain and Switzerland in 2013; and Indonesia gave notice of the termination of its BIT with the Netherlands in 2014. By virtue of "survival clauses", however, investments made before the termination of these BITs will remain protected for periods ranging from 10 to 20 years, depending on the relevant provisions of the terminated BITs.[29]

Apart from the terminations, the universe of investment-related treaties includes some renegotiated BITs. During the last decade, at more than 100 BITs were renegotiated. For instance, in 2005 China renegotiated BITs with Belgium-Luxembourg, the Czech Republic, Portugal, Slovakia and Spain, while Germany renegotiated BITs with Egypt and Yemen. The renegotiation trend is expected to increase further since, as discussed above a lot of BITs were signed in the 90s with an initial duration of 10 or 20 years.[30]

Many countries have accumulated a stock of BITs from the 90s, which were concluded before the rise of investor-State disputes, presented in previous chapter. The risks exposed by growing number of legal cases, together with countries' desire to ensure the sustainable development contribution of foreign investment, has led to the emergence of a new approach to investment agreements. Expiration of treaties signed in

[28] Of 148 terminated BITs, 105 were replaced by a new treaty, 27 were unilaterally denounced, and 16 were terminated by consent.

[29] Investments made by investors in South Africa before the BITs' termination will remain protected for another 10 years in the case of Spanish investments (and vice versa), 15 years in the case of Dutch investments and 20 years in the cases of German and Swiss investments. Investments made by Dutch investors in Indonesia will remain protected for an additional 15 years after the end of the BIT.

[30] UNCTAD. *Investor-State Dispute Settlement and Impact on Investment Rulemaking*. United Nations, Geneva, September 2007, p.3.

early 90s creates a window of opportunity to address inconsistencies in regime of BITs, and to update the global investment framework.

In light of the above, the definition of the term “investment” has become one of the most controversial issues in investment treaty arbitration, as it relates to jurisdiction of international tribunals and foreign courts, as in the absence of an investment, the jurisdiction of the arbitral tribunal fails *ratione materiae*.

The dominant approach in the vast majority of “old” BITs is to define "investment" in a way that is both broad and open-ended, covering practically all kinds of assets invested by an investor in the territory of the host country. A significant number of BITs, concluded in 90s, have included a standard definition of "investment", covering "*every kind of asset*". This broad conceptualization is typically complemented by an illustrative list of assets that are included within the definition. Such lists commonly include five categories of assets: movable and immovable property, interests in companies – including both portfolio and direct investment – contractual rights, intellectual property and business concessions. As an example, Article 1 of the UK Model BIT reads as follows:

> *õ í * c + " õ k p x g u v o g p v õ " o g c p u* *<u>every kind of asset</u>, owned or controlled directly or indirectly, and in particular, though <u>not exclusively, includes</u>:*
>
> *(i) <u>movable and immovable property</u> and any other property rights such as mortgages, liens or pledges;*
>
> *(ii) <u>shares in and stock</u> and debentures of a company and any other form of participation in a company;*
>
> *(iii) <u>claims to money</u> or to any performance under contract having a financial value;*
>
> *(iv) <u>intellectual property rights</u>, goodwill, technical processes and know-how;*

(v) *business concessions* conferred by law or under contract, including concessions to search for, cultivate, extract or exploit natural *t g u q w t*[31] (emphasis added)

Not only is the list of assets in this definition non exhaustive, due to "…*not g z e n w u k x g n,* but the use of broad generic terms, such as ‘‘*every kind of assets*’’, ‘‘*o q x c d n g " c p f " k o*’’ ‘‘*qexnccdknogu*’’ *rvtqq"* can complicate the issue whether the transaction falls within one of the categories of investments protected by the BIT for the jurisdictional purposes.

Such non-exclusive and open-ended approach has some noticeable disadvantages. It can be too liberal and risk the possibility that transaction not thought to be an "investment" at the time the agreement was entered into Might nevertheless become covered through such definition. Moreover, for example, "claims of money and claims under a contract having a financial value" is very broad and could conceivably encompass "ordinary commercial transactions" and "portfolio investments" unless they are specifically excluded.

As said before, the significant increase in the number of ISDS claims in last two decades has had an impact on the process of investment rulemaking. Numerous investment claims has led numerous countries to realize that the specific wording of BIT provisions does in fact matter, and that it can make a significant difference to the outcome of an investment dispute. Over the last years, a new generation of investment treaties has been gradually emerging. Some of them have deviated from the traditional

[31] 2008 UK Model Bilateral Investment Treaty: Agreement between the Government of The United Kingdom of Great Britain and Northern Ireland and the Government of [Country] for the Promotion and Protection of Investments.

open-ended, asset-based definition of investment. Instead, they have attempted to strike a balance between maintaining a comprehensive definition of investment and yet not covering assets that are not intended by the parties to be an investment covered by the BIT. One way of avoiding an overreaching definition of investment is to use an exclusive or/and closed-list definition. Or, in addition, specifically exclude some kinds of transactions from the BIT umbrella. As an example, Article 1139 of NAFTA provides an exclusive list of covered investments and the exclusion part:

> *ãinvestment means: í*
> *but investment <u>does not mean</u>,*
> *(i) claims to money that arise solely from*
>
> > *(i) commercial contracts for the sale of goods or services by a national or enterprise in the territory of a Party to an enterprise in the territory of another Party, or*
> > *(ii) the extension of credit in connection with a commercial transaction, such as trade financing, other than a loan covered by subparagraph (d); or*
>
> **l+"cp{"qvjgt*[32] (emphasis added) *vq"oqpg{ í ö*

In the 2012 US Model BIT, the definition is accompanied by explanatory footnotes unlike the UK Model, quoted above. The footnotes provide indications on the forms of debt, licenses and authorization which are likely to constitute an investment (footnotes 1 and 2). Footnote 1 explains the “*bonds, debentures, other debt instruments, and loans*” part as follows:

> *õSome forms of debt, such as bonds, debentures, and long-term notes, are more likely to have the characteristics of an investment, while other forms of debt,*

[32] North American Free Trade Agreement, San Antonio, 17 December 1992.

such as claims to payment that are immediately due and result from the sale of goods or services, are less likely to have such characteristics."[33]

As we can see, 2012 US Model BIT treats bonds and long term debt instruments as an investment. The next subparagraph presents the views on this matter from previous tribunals and examples of the investment agreements that exclude debt from the range of covered investments in different ways.

3.1.2. Jurisdiction over Sovereign Debt

As discussed above, many BITs treat "*any kind of asset*" as a protected investment and therefore include sovereign bonds. Some treaties explicitly list bonds as a covered investment. For example, Article 1(1) of the Italy-Argentina BIT in the unofficial English translation used by the tribunal in the famous ruling in Abaclat and Others v. Argentine Republic (2011) provides:

> *ãnvestment includes, without limitation:*
> *í*
> *(c) bonds, private or public financial instruments or any other right to performances or services having economic value, including capitalized*
> *t g x g p w[34] g u = í ö*

Such wording, even with Argentina rising objections to the translation and other jurisdictional issues, resulted in the tribunal's finding that the Argentina's bonds

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[33] 2012 U.S. Model Bilateral Investment Treaty: Treaty between the Government of the United States of America and the Government of [Country] concerning the Encouragement and Reciprocal Protection of Investment.

[34] Abaclat and Others v. Argentine Republic, ICSID Case No. ARB/07/5, Decision on Jurisdiction and Admissibility (4 August 2011), para.336.

are to be considered “investments” in the sense of Article 1(1) lit. (c) BIT and that the tribunal has the jurisdiction to decide over the claims, submitted by Italian holdout creditors.[35] The “sister-tribunal” in Ambiente Ufficio S.p.A. and others v. Argentine Republic (2013) case came to the identical decision over the same Italy-Argentina BIT.[36] What is important is that Italy-Argentina Bit was concluded in 1990, before the increase of investor-state disputes and its non-exclusive list and broad wording illustrate the “old” BIT drafting style, mentioned in the previous subparagraph.

At the same time, there are numerous treaties, which do not include sovereign debt in all possible forms, especially the ones, concluded in recent years.[37] For example, Article 1 of 2004 Canada Model BIT clearly excludes a loan to, or debt security issued by a Party or a state enterprise from the umbrella of BIT protection:

> *“investment means:*
> *… (iii) a debt security … does not include a debt security, regardless of original maturity, of a state enterprise;*
> *(iv) a loan to … does not include a loan, regardless of original maturity, to a state enterprise …”*[38] (emphasis added)

This model was applied to the Canada-Colombia FTA, signed in 2008. Footnote 11, which is related to the definitive Article 838 of the Investment chapter provides:

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[35] Ibid. 34, paras. 361, 501.
[36] Ambiente Ufficio S.p.A. and others v. Argentine Republic, (formerly Giordano Alpi and others v. Argentine Republic), ICSID Case No. ARB/08/9, Decision on Jurisdiction and Admissibility (8 February 2013), paras. 490, 495.
[37] See Australia-Chile FTA (2008), Article 10.1(j)(iii); Azerbaijan-Croatia BIT (2007); Chile-Japan FTA (2007), Article 105 etc.
[38] 2004 Canada Model Bilateral Investment Treaty: Agreement between Canada and [Country] for the Promotion and Protection of Investments.

õFor greater certainty, the following are not investments: í
(ii) a loan issued by one Party to the other Party; and
(iii) public debt operations o h " c " R c t v { " q t "[39] *c " u v c v g " g p v g t r t k u*

Another way to exclude sovereign debt from the investment listed is simply not to include portfolio investment at all, as is shown in Article 1(1) of the 2009 Turkey Model BIT:

õ V j g " v g t o " $ k p x g u v o g p v $ " o g c p u " g x g t { " m k p f "
activities, <u>acquired for the purpose of establishing lasting economic relations</u> in
v j g " v g t t k v q t { " q h " c p { " E q p v t c e v k p i " R c t v { í’”[40] (emphasis added)

What is interesting about this model BIT is that, along with some other treaties,[41] it excludes sovereign bonds and other debt instruments in a more sophisticated manner. These agreements, along with the ones, explicitly excluding only sovereign debt, are a prominent example of the “new” BIT drafting style, where states pay much more attention to the actual wording and definitions.

Although exclusion of public debt may increase investor nervousness about debt repayment, potentially discouraging investment, it allows states to implement programs of debt restructuring in case of default or financial difficulties without the risk of facing international arbitral proceedings brought by multiple holdout creditors sometimes only for the purpose of profiting from crisis, which will be further discussed in this paper.

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[39] Canada-Colombia Free Trade Agreement, Bogota, 21 November 2008
[40] 2009 Agreement between the Government of the Republic of Turkey and [Country] concerning the Reciprocal Promotion and Protection of Investments
[41] See NAFTA Article 1139; China-Germany BIT (2003) Article 1; EU-Mexico FTA (2000), Article 45; Japan-Singapore EPA (2002), Article 72a etc

3.2. ICSID Arbitration on Debt Instruments

Numerous procedural and jurisdictional aspects of the arbitration process are often not regulated in the texts of the investment agreements themselves. Instead, most of the existing treaties tend to rely on existing arbitration rules to clarify these matters, principally the ICSID Convention or the UNCITRAL rules. As the majority of known disputes continued to accrue under the ICSID Convention and the ICSID Additional Facility Rules, it is not surprising that a significant part of the jurisprudence in fact deals with the interpretation of the ICSID Convention and its interaction with the applicable BIT.

3.2.1. ICSID: Factual Background

International Center for Settlement of Investment Disputes was established by the World Bank during the 60s out of a belief that the existence of an international, and thus, neutral tribunal to resolve investment disputes would mitigate political risk and encourage foreign investment. The preamble to the Convention refers to:

> "*…the need for international cooperation for economic development, and the role of private international investment therein…*"[42]

For the first twenty years ICSID operated in relative obscurity, until the passage of NAFTA, and the proliferation of BITs since the early 90s, brought it to the

[42] Convention on the Settlement of Investment Disputes between States and Nationals of Other States (adopted 18 March 1965, in force since 14 October 1966) UNTS, vol. 575, p. 159, Preamble.

forefront of investor-state dispute resolution. Chapter 11 of NAFTA, as well as the overwhelming majority of BITs, provide for ICSID arbitration of investor-state disputes.[43] Additionally, many investors prefer ICSID to alternatives due to the unique enforcement mechanism, which is set forth in its Articles 53 and 54. Article 53(1) provides:

> *õ V j g " shall be binding on the parties and shall not be subject to any appeal or to any other remedy except those provided for in this Convention. Each party shall abide by and comply with the terms of the award . . 0*[44] (emphasis added)

The grounds for annulment of ICSID awards are very narrow.[45] The award is automatically enforceable against local assets of the debtor State in that country, to the same extent that any final local judgment would be enforceable against those assets. In the United States, this aspect of the Convention is implemented by 22 U.S.C. § 1650(a), which provides that an ICSID award "*shall create a right arising under a treaty of the United States*".[46] Anyway, historically, most awards have been voluntarily satisfied, thus making enforcement clauses unnecessary.[47] This may be due in part to center's affiliation with the World Bank.

The jurisdiction of ICSID tribunals depends not only on the terms of the applicable BIT, but also on the requirements provided in the Convention itself. Consequently, to a certain extent, interplay exists between the definitions of investment

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[43] Cristoph Schreuer. *The ICSID Convention: A Commentary*. Cambridge: Cambridge University Press, 2001, p. 211.
[44] Ibid.42, art. 53(1).
[45] The annulment mechanism is outlined in Article 52 of the ICSID Convention
[46] 22 U.S. Code § 1650a - Arbitration awards under the Convention
[47] Edward Baldwin, Mark Kantor, Michael Nolan. "Limits to Enforcement of ICSID Awards." *Journal of International Arbitration*, vol. 2, issue 1(2006), pp. 1–24, p. 4–5

contained in the BITs and Article 25 of the Convention. The so called ''double-barreled test'' approach has been applied by several arbitral tribunals.[48] As explained in a recent award in Phoenix Action, Ltd v. The Czech Republic (2009):

> *÷ í-this double test entails that the jurisdiction ratione materiae of the Tribunal rests on the inte t u g e v k q p " q h " v''j g " v y q " f g h k p k v k q p u í*[49]

Article 25 of the Convention provides that jurisdiction of ICSID shall extend:

> *õ íto any legal dispute arising directly out of an investment, between a Contracting State . . . . and a national of another Contracting State, which the parties to the dispute consent in writing to submit . . . ö*[50](emphasis added)

The controversial part is that the Convention does not define the term "investment." Although several definitions were proposed at the drafting stage, none of them made it into the Convention.[51] Since the only thing the drafters eventually could agree on was the fact that they did not agree, they decided to leave the definition of "investment" open for subsequent determination by the states in the relevant investment treaties.[52] Meantime, over the last decades, arbitration tribunals have stated that the term "investment" as used in Article 25(1) of the Convention has certain objective boundaries, which have to be respected in order to allow ICSID tribunals to have jurisdiction to hear a dispute. This method had been applied for the first time in Fedax N.V. v. The

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[48] See Abaclat and Others v. Argentine Republic (2011), Ambiente Ufficio S.p.A. and others v. Argentine Republic (2013), Malaysian Historical Salvors Sdn, Bhd v. Malaysia (2007) etc.
[49] Phoenix Action, Ltd v. The Czech Republic, ICSID Case No ARB/06/5, Award (15 April 2009), para. 74.
[50] Ibid. 42, art. 25(1).
[51] Ibid. 43, p. 356-57.
[52] International Bank for Reconstruction and Development. *Report of the Executive Directors of the International Bank for Reconstruction and Development on the Convention on the Settlement of Investment Disputes between States and Nationals of Other States.* IBRD, Washington, 18 March 1965.

Republic of Venezuela (1997), but it commonly became known informally as the ‘‘Salini test’’, taking the name of the award in Salini Construtorri S.P.A. v. Morocco (2001). The hallmarks of the Salini test, stated by the tribunal in Fedax N.V. v. The Republic of Venezuela (1997), reads as follows:

> *÷ ÷ V j g " d c u k e " h g c v w t g u " q h " c p " k p x g u v o g p v " j c x g duration, a certain regularity of profit and return, assumption of risk, a substantial commitment and significan e g " h q t " j q u v " U v c v g ø u " f g x g n q*[53]

These criteria have been applied consistently by tribunals and were referred to expressly in several decisions including Joy Mining Machinery Limited v. Egypt (2004), Jan de Nul N.V. & Dredging International N.V. v. Egypt (2006), Malaysian Historical Salvors Sdn, Bhd v. Malaysia (2007), Bayindir Insaat Turizm Ticaret Ve Sanayi A.S. v. Islamic Republic of Pakistan (2005) and already mentioned Abaclat and Others v. Argentine Republic (2011) and Ambiente Ufficio S.p.A. and others v. Argentine Republic (2013) cases.

According to the Salini test, the investor’s commitment to the investment must be evidenced by a certain length of time. Case law and doctrine have established that the required duration is of at least 2 years. The Salini Construtorri S.P.A. v. Morocco (2001) tribunal, for instance, verified that:

> *÷ ÷the transaction, therefore, complies with the minimal length of time upheld by the doctrine, which is from 2 to 5 { g c t u ø ø í*[54]

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[53] Fedax N.V. v. The Republic of Venezuela, ICSID Case No. ARB/96/3, Decision of the Tribunal on Objections to Jurisdiction (11 July 1997), para. 43.

[54] Salini Construtorri S.P.A. v. Morocco, ICSID Case No. ARB/00/4, Decision on Jurisdiction (23 July 2001), para 54.

An investment should imply some expenditures in forms of money, assets or efforts in consideration of a return or profits. For instance, a contract of a one-time sale of goods does not fulfill this requirement. In Joy Mining Machinery Limited v. Egypt (2004), the tribunal stated that as bank guarantees at issue did not provide regular profit and returns they were not an investment under the Article 25 of ICSID.[55]

The third requirement of the test is that the transaction entailed an economic risk ''*in the sense of an uncertainty regarding its successful outcome*''[56] The mere non-performance by the other contracting party of its obligations does not meet the standard of investment risk. If the non-performance of a contractual obligation characterizes an investment, any contract would then be considered as an investment. This was confirmed by the tribunal in Joy Mining Machinery Limited v. Egypt (2004), which stated that:

> *÷ í risk there might be indeed, but it is not different from that involved in any commercial contract, including the possibility of the termination of the Contract í ø*[57]*ø*

and accordingly ruled that such normal commercial risk was not sufficient.

Furthermore, an investment requires a commitment of the investor, which does not depend on the amount of the expenditures exposed. Indeed, in Mihaly International Corporation v. Sri Lanka (2002) the arbitral tribunal considered that:

> *÷ í the question whether expenditure constitutes an investment or not is hardly to be governed by whether or not the expenditure is large or small í ø*[58]*ø*

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[55] Joy Mining Machinery Limited v. Egypt, ICSID Case No. ARB/03/11, Award on Jurisdiction (4 August, 2004), para. 57.
[56] Patrick Mitchell v. Democratic Republic of the Congo, ICSID Case No. ARB/99/7, Decision on the Application for Annulment of the Award (1 November 2006), para. 27.
[57] Ibid. 55, para. 57.
[58] Mihaly International Corporation v. Sri Lanka, ICSID Case No. ARB/00/2, Award (15 March 2002), para 51.

The reference to the contribution to the economic development of the host state, which is the last Salini requirement, is found in the Preamble of the ICISD Convention and in most BITs. The Preamble to the ICSID Convention reads:

> *"…Considering the need for international cooperation <u>for economic development</u>…"*[59] (emphasis added)

The tribunal in <u>Ceskoslovenska Obchodni Banka v. Slovakia</u> (1999) found that such wording permits to infer that the transaction which contributes to the economic development of the host State may be an investment.[60] Here we come to an issue whether the sovereign debt, which was restructured due to the default (read "economic crisis") can be an "investment" under the ICSID, as obviously it is impossible to speak about the contribution to the economic development if a state is in default.

3.2.2. Jurisdiction over Sovereign Debt

Treatment of sovereign debt instruments as "investments" for the purposes of the Article 25(1) of ICSID Convention so far has attracted considerable discussion among scholars and in case law.[61]

The structure of modern bond market is certainly convenient for participants. From a legal perspective, however, the implications are quite opposite. There is a complex web of transactions and related legal relationships, stretching across numerous

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[59] Ibid. 42, Preamble.
[60] Ceskoslovenska Obchodni Banka v. Slovakia, ICSID Case No. ARB/97/4, Decision on objection to jurisdiction (24 May 1999), para. 64.
[61] Michael Waibel. "Opening the Pandora's Box...". *The American Journal of International Law*, vol. 101, no. 4 (Oct., 2007), pp. 711-759.

jurisdictions. Therefore, before answering the question whether bonds qualify as "investments" in terms under ICSID Convention, this paper will first determine whether the various transactions involved in bonds acquisition can be treated holistically, or whether they have to be disentangled. There are two basic views: one can either rely on any of the individual transactions, from the underwriting of the bond to their acquisition in secondary markets; or one can look at them as one economic operation.

The case law is mostly in favor of the latter option. In Fedax N.V. v. The Republic of Venezuela (1997) the tribunal decided that it had jurisdiction over a dispute, which involved six promissory notes issued by Venezuela. Even though the case concerned promissory notes and not bonds, it provides an important point of reference. Venezuela argued that the promissory notes did not constitute investments in terms of the ICSID Convention, because their acquisition in the secondary market did not involve a long term transfer of capital for the purpose of acquiring interests in or shares of a corporation.[62] The tribunal, however, did not follow the Respondent's argumenta. It decided not to deal with the purchase of the promissory notes in isolation, but to look at the entire operation as a whole:

> *õ ín q c p u " s w c n k h { " c u " c p " k p x g u v o g p v " y k v j k p " K E circumstances, the purchase of bonds. Since promissory notes are evidence of a loan and a rather typical financial and credit instrument, there is nothing to prevent their purchase from qualifying as an investment under the Convention in the circumstances of a particular case such as this í ô*[63] (emphasis added)

[62] Ibid.53, para. 19.
[63] Ibid. 53, para. 29.

Although the tribunal acknowledged that commercial disputes with respect to purchase fall outside of ICSID's jurisdiction,[64] it found that the transaction in this case was distinguishable. Tribunal stated that the promissory notes are in line with requirements: were issued under Venezuela's Public Credit Law, and thus were related to the state's economic development; the notes had a maturity extending beyond the fiscal year; and finally, the amount of capital invested – approximately USD 600,000 – was substantial.[65] The Fedax N.V. v. The Republic of Venezuela (1997) decision lends strong support for the view that ICSID tribunals should have jurisdiction over the bondholders' claims. Subsequent ICSID tribunals' decisions tend to rely on Fedax N.V. v. The Republic of Venezuela (1997) for the proposition that a loan qualifies as an "investment" for purposes of Article 25(1).[66]

Although strongly criticized,[67] Fedax N.V. v. The Republic of Venezuela (1997) decision is further supported by an award on jurisdiction in Abaclat and Others v. Argentine Republic (2011) case, which is the first known case to deal with sovereign bonds directly. The tribunal refused to disentangle the various transactions and rather treated them as one economic operation.[68] It reasoned that the issue of the bonds, their distribution and subsequent trading in secondary markets only made sense together as none of them would have taken place individually. Most importantly, the underwriter

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[64] Ibid 53, para. 28.
[65] Ibid. 53, paras. 42-43.
[66] Ibid. 60, paras. 71-72, 76.
[67] For a contrary view, arguing that the Fedax N.V. v. The Republic of Venezuela (1997) and Ceskoslovenska Obchodni Banka, A.S. v. Slovak Republic (1999) awards were wrongly decided, *see* Ibid. 61, p. 711-759.
[68] Ibid. 34, para. 358.

would never have engaged in the issue process if it would not have been able to resell the bonds. It concluded that:

> *õ í bonds and security entitlements therein cannot be regarded as two separate investments relating to different rights or values í ö*[69]

The tribunal in Ambiente Ufficio S.p.A. and others v. Argentine Republic (2013) followed the same approach and seconded the reasoning of Abaclat and Others v. Argentine Republic (2011) when invoking a doctrine of general unity of an investment operation which it inferred from existing case law.[70] It concluded that the operation was:

> *õ í correctly characterized í as the overall loans which made funds available to finance v j g " T g u r q p f g p v ,ø with each Claimant holding "a p g g f u proportionate share of that investment í . To seek to split up bonds and security entitlements into different, only loosely and indirectly connected operations would ignore the economic realities, and the very function, of the bond issuing process í ö*[71]

Again, a lot of scholars and even the respective dissents expressly reject the assumption of an economic unity.[72] The Dissenting Opinion to the Abaclat and Others v. Argentine Republic (2011) by Georges Abi-Saab pointed to the fact that the underwriter bears the placement risk, and that the purchase price paid for the entitlements is not paid to the issuer, but to the prior holder of the entitlement.[73] Furthermore, dissent in Ambiente Ufficio S.p.A. and others v. Argentine Republic (2013) stated “bonds” and

[69] Ibid. 34, para. 359.
[70] Ibid. 36, para. 422.
[71] Ibid. 36, para. 425.
[72] Abaclat and Others v. Argentine Republic, ICSID Case No. ARB/07/5, Dissenting Opinion by Professor Georges Abi-Saab (28 October 2011), para. 69; Ambiente Ufficio S.p.A. and others v. Argentine Republic (formerly Giordano Alpi and others v. Argentine Republic), ICSID Case No. ARB/08/9, Dissenting Opinion by Santiago Torres Bernardez (2 March 2013), para. 151.
[73] Ibid 72.

"security entitlements" are materially and legally different "financial products" issued at different moments of time, in different markets and by two different juridical persons".[74]

Moreover, as to the requirements of the Salini test, the sovereign bonds do not embrace investment risks. This is because the repayment obligation is fixed, unconditional, and not contingent on the success or failure of a commercial undertaking or capital project for which the fund was used.[75] Regardless of how the issuing country makes use of the resources, the bondholder will be repaid. Sovereign bonds only assume the risk of state's nonperformance or non-payment, which is purely commercial risk not an investment risk, as explained above.

Treatment of sovereign debt instruments as "investments" for the purposes of the Article 25(1) of ICSID Convention so far has attracted considerable discussion among scholars and in case law, especially after such controversial and dissented decisions on jurisdiction in Abaclat and Others v. Argentine Republic (2011) and Ambiente Ufficio S.p.A. and others v. Argentine Republic (2013). As international investment law does not follow the *stare decisis* and there is no international bankruptcy procedure, the only way to definitely exclude sovereign bonds from the ICSID arbitral tribunals' jurisdiction is to expressly exclude debt instruments and private debt from the scope of BIT, in a way suggested earlier in this Chapter.

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[74] Ambiente Ufficio S.p.A. and others v. Argentine Republic (formerly Giordano Alpi and others v. Argentine Republic), ICSID Case No. ARB/08/9, Dissenting Opinion by Santiago Torres Bernardez (2 March 2013), para. 155.
[75] Ibid 61, p.726.

CHAPTER IV: INVESTMENT DISPUTES OVER SOVEREIGN DEBT RESTRUCTURING

This Chapter begins with a review of international arbitration concerning debt instruments, presenting the unprecedented Abaclat and Others v. Argentine Republic (2011) case and other sovereign debt related disputes, and sovereign debt litigation under U.S. law. It further provides a survey on the positive and negative implications of investment disputes over sovereign debt restructuring, such as limitation of the "opportunistic defaults" on one side and vulture funds profiting from crisis on the other.

4.1. Sovereign Debt Litigation in United States

In contrast to the private debtors, there is no bankruptcy procedure, and thus protection, for financially impaired sovereigns, though such a system has been advocated for since at least the time of Adam Smith.[76] When a state cannot serve its debts, the only recourse is to enter in negotiations with creditors. Unlike the bankruptcy process for private debtors, participation in a sovereign debt restructuring is optional, and creditors may choose to "holdout" by bringing lawsuits in order to obtain judgments.

As for the sovereign debt litigation in national courts, New York and London continue to be the primary locations for external sovereign borrowing and related legal disputes. A bond's governing law plays a major role for debt restructurings as it predefines the jurisdiction for potential litigations. In the past decades about 80 percent

[76] Charles Seavey. "The Anomalous Lack of an International Bankruptcy Court". *244 Berkeley Journal of International Law*, vol. 499 (2006) (citing Adam Smith. *The Wealth Of Nations* (1776))

of international bonds were issued under New York law, while most of the remainder was issued under English law.[77] The dominance of US cases is partly due to the fact that most Latin American defaulters issued their debt under New York law. The picture looks different for the European Union countries where since 2003 public bonds have been predominantly issued under domestic laws.[78] Overall, the studies identify 120 instances of litigation by foreign commercial creditors against 25 defaulting sovereigns (not counting multiple lawsuits by the same creditor). 102 cases were filed in the United States and only 15 cases in England.[79]

For a long time, a central notion in international economics was that sovereign debt cannot be enforced, as there are legal principles protecting debtor governments, in particular the doctrine of "absolute sovereign immunity", which provides that a government cannot be sued in foreign courts.[80] The lack of an enforcement mechanism against sovereigns was perhaps the most fundamental imperfection of international capital markets".[81] Recent developments, however, completely undermine this view of non-enforceable sovereign debt. States that default on their debts can be easily hauled into national courts just like private debtors. This has been particularly demonstrated in the case of Argentina, which defaulted in 2001 and has since fought a legal battle with

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[77] Julian Schumacher, Christoph Trebesch and Enderlein, Henrik. *Sovereign Defaults in Court*. Free University Berlin/Hertie School, May 6, 2014.
[78] Ibid. 22, p.14.
[79] Ibid. 77.
[80] According to the Legal Dictionary: "Sovereign immunity is a judicial doctrine that prevents the government or its political subdivisions, departments, and agencies from beingsued without its co nsent. The doctrine stems from the ancient English principle that the monarch can do no wrong."
[81] Carmen Reinhart and Kenneth Rogoff. *This Time Is Different: Eight Centuries of Financial Folly*. Princeton: Princeton University Press, 2009, pp.53.

holdout creditors, with more than 150 suits filed.[82] But Argentina is not an exception but part of a recent global trend. The legal consequences of sovereign debt restructurings are much greater than commonly thought. Almost 50% of sovereign defaults in last decades involved legal disputes, compared to less than 10% in the 80s and early 90s. [83] And more and more states are affected.

The reason is that in the modern era, most sovereign lending is bond lending, as described in Chapter II. And when sovereigns issue bonds in foreign markets, they often include "waivers of immunity" from suit and other terms designed to facilitate legal enforcement.[84] It other words, when a state issues bonds governed by New York law, it waives its immunity from suit in New York courts. For example, the Turkey's 6.00% Notes due January 14, 2041 provide that:

> *õTurkey will irrevocably waive, to the fullest extent permitted by law, any immunity, including foreign sovereign immunity, from jurisdiction to which it might otherwise be entitled in any action arising out of or based on the debt securities which may be instituted by the holder of any debt securities in any state or federal court in the City of New York or in any competent court in Turkey.*[85]

Moreover, foreign sovereigns are no longer immune from suit not only when they have waived their immunity in a bond contract, but also when they engage themselves in commercial acts. The most significant change occurred in 1952 (Figure 10. Evolution of Litigation Environment), when the US Department of State issued the

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[82] Jeff Hornbeck. *C t i g p v k p c ø u " F g h c w n v g f " U q x g t g k* United *" F g d v < " F g c* States Congressional Research Service, February 2013.
[83] Ibid. 77, p.10-11.
[84] Mark C. Weidemaier. "Contracting for State Intervention: The Origins of Sovereign Debt Arbitration". *Law and Contemporary Problems*, vol. 73, no. 4 (2010).
[85] The Republic of Turkey, Prospectus for USD 1 billion of 6.00% Notes Due 2041, at 12 (Aug. 10, 2006).

Tate Letter announcing the adoption of the restrictive theory of sovereign immunity, which was later codified into US law through the Foreign Sovereign Immunities Act of 1976 (FSIA). Important parts for this paper are 28 U.S.C. § 1605(a)(1) and (2):

> *(a) A foreign state shall not be immune from the jurisdiction of courts of the United States or of the States in any case ô*
>
> > *(1) in which the foreign state has waived its immunity ...;*
> >
> > *(2) in which the action is based upon a commercial activity carried on in the United States by the foreign state; í* [86]

Shortly thereafter, the United Kingdom passed a similar law, the State Immunity Act of 1978,[87] and many other countries followed (Figure 10. Evolution of Litigation Environment). As a result, sovereigns can now be held legally accountable for breach of commercial contracts. Therefore, even without a waiver of immunity included in bond contracts, national courts may have jurisdiction to hear claims arising out of sovereign debt restructuring.

The historical event that provided the impetus for the first wave of lawsuits by professional plaintiffs was the Latin American debt crisis of the early 80s. The most prominent and representative case arising thereof is Republic of Argentina v. Weltover (1992), which gave a definitive blow to the defense based on sovereign immunity. The Supreme Court confirmed that issuing sovereign debt on international capital markets qualifies as a commercial activity:

> "…when a foreign government acts, not as regulator of a market, but in the manner of a private player within it, the foreign sovereign's actions are "commercial" within the meaning of the FSIA. Moreover, … commercial

[86] 28 U.S. Code § 1605 - General exceptions to the jurisdictional immunity of a foreign state.
[87] 28 U.S. Code §§ 1330, 1332, 1391(f), 1441(d), and 1602-1611.

> character of an act is to be determined by reference to its "nature" rather than its "purpose,…."[88]

In another early decision, the Second Circuit also rejected the common-law immunity defense to nonpayment of sovereign debt.[89] This decision essentially granted US courts the jurisdiction over all sovereign loans and bonds issued under US (New York) law. Figure 10. Evolution of Litigation Environment shows that along with this cases, from the early 90s on, the sovereign debt litigation regime was completely changed with the entrance of a new type of professional plaintiffs: specialized debt funds, or, as they are usually called, vulture funds.[90] They are often based in tax havens, such as the British Virgin Islands or Liechtenstein, and act as temporary vehicles, being established solely to pursue a specific legal case. More details will be provided in the following subparagraph of this paper.

The late 90s were the "heyday" of the sovereign debt litigation, when the hedge fund Elliott used a new interpretation of the *pari passu* clause in Elliott Assocs., L.P. v. Banco de la Nacion (1999). The plaintiff argued that the clause prohibited Peru from paying its restructured creditors without making a payment to holdouts as well. Rather than risking a default on its entire stock, Peru quickly settled at face value, transferring about USD 58 million to Elliott. Not surprisingly, this encouraged a wave of similar litigations. Ultimately, however, no other plaintiff succeeded until 2014, when Argentina suffered a notable defeat, when the New York Second Circuit Court of

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[88] Republic of Argentina v. Weltover, Inc., 504 U.S. 607, 614 (1992).
[89] Allied Bank Int'l v. Banco Credito Agricola de Cartago, 757 F.2d 516, 522–23 (2d Cir. 1985).
[90] Vulture funds are companies that purchase the debt of poorer countries at reduced rates then sue that nation for the full value of the debt plus interest.

Appeals ruled in favor of NML, which as surprisingly a subsidiary of Elliott, turning the case into the "sovereign debt trial of the century".[91]

The current sovereign debt litigation environment can be best described as a hunt for assets (Figure 10). The legal battleground has moved from suit immunity to immunity from attachment,[92] although sovereign immunity laws, including the FSIA, continue to protect many government assets from attachments. ICSID's Article 55 also explicitly preserves any immunity from execution available to the sovereign.[93]

Since the early 2000s and Argentina's debt restructuring, vulture funds, mentioned earlier, have stepped up their efforts by trying to seize a variety of states' assets around the globe: Argentina's government airplane, its central bank assets and social security funds in the US, the Argentinian vessel ARA Libertad, Argentina's stake in the satellite launch firm SpaceX, and even Argentine dinosaur fossils on exhibition in Europe.[94] Aurelius Capital Partners, a fund created by former Elliott managers – tried to execute social security funds of Argentine citizens that had been invested in New York by private pension fund managers.[95] Although, most of these attempts have been unsuccessful and attachments were ultimately rejected by US and European courts,[96]

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[91] NML Capital, Ltd. v. Argentina, 727 F.3d 230 (2d Cir. 2013), cert. denied, 134 S. Ct. 2819 (June 16, 2014).

[92] Attachment is the seizing of a person's property to secure a judgment or to be sold in satisfaction of a judgment. Black's Law Dictionary 145 (9th ed. 2009).

[93] Ibid. 43.

[94] George K. Foster. "Collecting from Sovereigns: The Current Legal Framework for Enforcing Arbitral Awards and Court Judgments Against States and Their Instrumentalities, and Some Proposals for its Reform". *Arizona Journal of International and Comparative Law*, vol. 25, no. 3 (2008).

[95] Aurelius Capital Partners, L.P. v. Republic of Argentina, 584 F.3d 120 (2d Cir. 2009), *cert denied* 130 S. Ct. 1691 (2010).

[96] Ibid. 77, p.8.

these data strongly indicate that creditor strategies have become more aggressive and that the direct costs of legal disputes are increasing.

4.2. International Arbitration concerning Debt Instruments

This paper shows that the regime for effective sovereign debt restructuring is very fragile. When sovereign debt is defined and covered by an investment agreement, as discussed in Chapter III, numerous conflicts could arise. After the Argentina restructuring of USD 100 billion of debt three times between 2001 and 2010, although 92% of bondholders' accepted the deal, some holdouts, in particular numerous vulture funds, filed over 150 cases in the United States, where 158 suits have been filed.[97] Moreover, for the first time ever, a number of those holdouts filed claims under Italy-Argentina BIT to the ICSID for approximately $4.3 billion.[98] The Argentina situation is yet to be decided on merits, but the unprecedented decisions on jurisdiction in Abaclat and Others v. Argentine Republic (2011) and Ambiente Ufficio S.p.A. and others v. Argentine Republic (2013) reveals that the regime for sovereign debt restructuring remains far from adequate. Up to these decisions, international arbitral tribunals did not have a precedent. These decisions can encourage other holdout creditors to consider investment treaty arbitration as a means of recourse against the defaulting issuer. Moreover, the Ambiente Ufficio S.p.A. and others v. Argentine Republic (2013) tribunal

[97] Ibid. 82.

[98] Abaclat and Others v. Argentine Republic (2011), Ambiente Ufficio S.p.A. and others v. Argentine Republic (2013).

even emphasized that sovereign bonds will naturally give rise to large numbers of claims.[99] And this is really happening. Although Greek debt restructuring in 2012 was very favorable to creditors and 95.7% of private bondholders accepted the deal,[100]some speculators wanted to gain from the haircut.

Figure 11 shows the timeline of the Greek debt problems. In April 2010, rating agency Standard & Poor's categorized Greece's debt as "junk".[101] Postová Bank, a Slovakian institution, bought Greek bonds in early 2010, after credit agencies already warned of the risk of default and the bonds value went down. Some observers even say that Postová Bank bought the Greek bonds at a moment when others were trying to get rid of them.[102] Two years later, the bank refused the Greek restructuring deal and claimed to have lost millions due to this debt restructuring. On 20 May 2013, the Postová Bank and its Cypriot shareholder, Istro Kapital, sued the Greek Government at an international investment tribunal under the auspices of ICSID (Figure 11).[103]It is worth noticing that the investment treaties used in this case are between Slovakia and Greece and between Cyprus and Greece, and thus between European Union member

[99] Ibid. 36, paras. 159-163.

[100] Robin Wigglesworth. "Vulture funds come under sovereign fire." *Financial Times* (24 April 2013).

[101] Richard Wachman and Nick Fletcher. "Standard & Poor's downgrade Greek credit rating to junk status." *The Guardian* (27 April 2010).

[102] Elena Moya. "Investors rush to sell Greek bonds." *The Guardian* (8 April 2010); David Oakley, Quentin Peel, and Kerin Hope. "Greek bonds plunge despite bail-out pledge." *Financial Times* (26 April 2010).

[103] Poštová Banka, A.S. And Istrokapital Se v. The Hellenic Republic, ICSID Case No. ARB/13/8, Award (9 April 2015).

states, adding an extra attention to the situation since the European Commission has repeatedly questioned the validity of these BITs.[104]

After almost 2 years of arbitration proceeding, on 9 April 2015 the tribunal presented the award, claiming it has no jurisdiction over this case.[105] The award presents the detailed discussion of the *ratione maritae* criteria based on the wording of the applicable BITs. This tribunal decision is of a great importance for the global community and international investment law framework. As seen in Chapter II, nowadays there are numerous countries that face a risk of a debt crisis, and at some point in the future debt defaults will certainly occur. It is, therefore, important to ensure that investment treaties and international investment law do not prevent debtor nations from conducting debt restructurings in a manner that facilitates economic recovery and development. The tribunals finding that they have jurisdiction over the holdouts' claims, and therefore, that the scope of investment treaties and sovereign debt restructuring may overlap will open a window for disappointed bondholders all over the world to initiate legal proceedings under international arbitration and therefore undermine the ability of nations to recover from financial crises and thus broaden the impact of such crises, not only for particular state, but for the world economy as a whole.

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[104] Cecilia Olivet. "Intra-EU Bilateral Investment Treaties: A test for European solidarity." *TNI* (2013)

[105] Ibid. 103, para. 350, 379

4.3. Positive Implications

Some commentators believe that the investment arbitration and litigation in national courts may have a positive impact on the debt restructuring process and the debt markets. These opinions usually include the following aspects.

4.3.1. Promoting Investments by Promulgating the Rule of Law?

Although there are different kinds of mechanisms to avoid problems under sovereign debt restructuring, none of them can provide relief as effective as international investment arbitration does. It is because, as said earlier in Chapter II, ICSID award has the advantage of being recognized and enforced in other states. Thus, scholars suggest that international arbitration is a way to protect an investor and facilitate foreign direct investment.[106] On the other hand, it would be rather challenging to isolate the effect of individual treaty right, particularly the role of the ISDS mechanism with respect to sovereign bonds.

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[106] Merchant, Khozem. "Snow Calls for an Arbitration System to Ease India Fears." Financial Times (8 November 2005).

4.3.2. N k o k v c v k q p " q h " v j g " õ Q r r q t v w p k u v k e " F g h c w n

The duty of sovereign borrowers is to act responsibly may be seen as a soft norm that has yet to crystallize in the *opinio juris*:

> õ*The borrower should avoid opportunistic behavior and arbitrary discrimination among creditors; and it should respect the voluntary basis of the process and the seniority of debts ... ö*[107] (emphasis added)

The investment arbitration and litigation can improve the current sovereign debt market by limiting potential “opportunistic defaults.” These kinds of default occurs when sovereigns deliberately fails to make payment of its debts for which it is actually able to pay.[108] Policymakers just choose to save a state’s resources for domestic needs instead of repaying foreign creditors. Furthermore, a sovereign may be unwilling to enact special reforms or pursue the fiscal policy adjustments necessary to achieve debt sustainability.[109] As a result, a government may default and restructure its debt even though it is practically capable of repaying the debts in full. Ecuador’s default in November 2008 is an example of a sovereign opportunistically defaulting. Ecuador suspended payment on two bonds after declaring the debts “immoral,” “illegal,” and “illegitimate.” This default was not triggered by a severe economic crisis, as the ratio of public debt to GDP at the time of default was only 23%.[110] To compare, Argentina’s

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[107] UNCTAD. *Draft Principles on Promoting Responsible Sovereign Lending and Borrowing*. United Nations, Geneva, April 2011.
[108] Tomz, Michael and Mark L.J. Wright. *F q " E q w p v t k g u " F g h c* Federal *" k p " õ D c f " V* Reserve Bank of San Francisco, Working Paper (No. 2007-17), 2007.
[109] Ibid. 20.
[110] Ibid. 20, p. 67.

government debt ratio after its 2001 default was 130%,[111] and still this default gave rise to the holdout claims, as presented above.

Distinguishing between a necessary default and an opportunistic one can be challenging for creditors. Even states in financial distress can arguably have some ability repay their debts. Greece, for example, could theoretically sell the Parthenon or some of its sovereign territory.[112]

Opportunistic defaults let sovereigns to reduce their debt, putting the cost of default on foreign creditors. And when it is easier to restructure, more restructuring will occur.[113] Creditors do not wish to weaken the binding role of debt by giving the borrowers as easy way to walk away from their obligations. Investment arbitration may help improve the sovereign debt market by avoiding this kind of moral hazard.[114]

4.4. Negative Implications

On the contrary, the recent multiplication of disputes, the unpredictability of treaty interpretations by the tribunals, the increase in financial amounts involved have raised concerns on the part of states and practitioners. The negative opinions are explained as following.

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[111] Ibid. 34, para. 63.
[112] Stephen J. Choi, Mitu Gulati and Eric A. Posner. *The Evolution of Contractual Terms in Sovereign Bonds*. Journal of Legal analysis, vol.4, no. 131, 133 (2012), p. 132–33.
[113] Dixon, L. and Wall, D. Collective action problems and collective action clauses. *Bank of England, Financial Stability Review* (June 2000), pp.142-151.
[114] Roa, Felipe Suescun De. "Investor-State Arbitration in Sovereign Debt Restructuring: The Role of Holdouts". *Journal of International Arbitration*, vol. 30, no. 2 (2013), p. 131.

4.4.1. Disruption of Sovereign Debt Restructuring

There is a great concern of international community that that investment arbitration could hinder the ability of defaulting nation and its creditors to negotiate the deals and thus raise the cost of process of sovereign debt restructuring.[115] A possibility of successful investment arbitration will encourage bondholders not to participate in restructurings at all.

The IMF often reminds that past debt restructurings have "often been too little and too late"[116] and, therefore, often failed to re-establish financial sustainability of a state in a durable way. Such uncertainty in the legal regime showed to only delay the sovereign debt restructurings for 7.4 years on average.[117] Finally, international arbitration cannot solve the problems arising from sovereign debt restructuring, one of which is country's payment capacity. Award of any kind cannot solve the financial problems, decrease indebtedness or create the assets which a defaulting state can use to repay its debts.

[115] Gallagher, Kevin P. *The New Vulture Culture: Sovereign Debt Restructuring and Trade and Investment Treaty*. The IDEAs Working Paper Series (No. 02/2011), July 2011.
[116] International Monetary Fund. *Sovereign debt restructuring ô recent developments and kornkecvkqpu"hqt"vjg"hwpf)u"ngicn"cpf"rqnke{"htcog* . IMF, Washington, 26 April 2013.
[117] Mark L. J. Wright. *Sovereign Debt Restructuring: Problems and Prospects.* University of California and National Bureau of Economic Research working paper. 20 September 2011, p. 169.

4.4.2. The spillover effects of litigation

As discussed already by many scholars, legal disputes seem to undermine government access to international capital markets. In years with arbitration of litigation over sovereign debt restructurings, bond issuance drops close to zero. As an example, between 2000 and 2010, there was not a single instance in which a government facing a creditor lawsuit in New York also placed a new sovereign bond issuance in this jurisdiction.[118] As such, defaulting governments are excluded from foreign financial markets during and after defaults. Holdout litigation and respective ICSID cases are also associated with a massive decline in international trade of the state involved.[119] Creditors that try to retaliate against sovereigns via legal means are throwing sand in the wheels of the already defaulting economy.

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[118] Rohan Pitchford and Mark L. J. Wright. *Holdout Creditors in Sovereign Debt Restructuring: A Theory of Negotiation in a Weak Contractual Environment*. NBER Working Paper (No. 16632), December 2010.

[119] Benjamin, David and Wright, Mark L. J. *Recovery Before Redemption: A Theory of Delays in Sovereign Debt Renegotiations*. Department of Economics, University of California, Los Angeles (April 8, 2009).

4.4.3. Profiting from Crisis

Never let a good crisis go to waste.[120]

As described in the beginning of this Chapter, vulture funds are investors who specialize in obtaining debt in the secondary markets at prices far below face value and then holdout of the restructuring deal, demanding the payment of the full face value. They tend to share three main characteristics: (i) refusal to participate in negotiations; (ii) litigation initiated recovery of total debt; and (iii) they are based in known tax havens, for example British Virgin Islands).[121]

They often use legal tactics that disrupt a sovereigns' trade and capital flows, attempting to attach and seize state property abroad, such as oil tankers, export revenues, presidential airplanes and interest payments to other creditors. For example, in the Republic of Congo holdout creditors blocked the oil exports for years.[122] Hedge funds tend to profit from crisis, and as Robert Marquardt, founder of vulture fund Signet, stated during the conference in Monaco:

õ We Greek crisis is certainly a <u>great chance to make money...</u> ö[123]

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[120] Winston Churchill cited in: Cecilia Olivet and Pia Eberhardt. *Profiting from Crisis: How eqtrqtcvkqpu"cpf"ncy{gtu"ctg"uecx.gpikpi"rtqhkvu"* Amsterdam: Transnational Institute and Corporate Europe Observatory, March 2014.

[121] Elizabeth Broomfield. *Subduing The Vultures: Assessing Government Caps on Recovery In Sovereign Debt Litigation.* Columbia Business Law Review, vol. 473, 486 (2010).

[122] Ibid. 77, p.2.

[123] Philip Aldrick. "Vulture funds to profit from a second Greek bailout." *The Telegraph* (25 June 2011).

The strategy used by vulture funds has been widely criticized by sovereigns, courts, and commentators.[124] To deter litigation by minority bondholders in future crises European Union decided to undergo a legal reform by introducing collective action clauses, which will be discussed in the next Chapter, in all bond issues from 2013. Other related policy initiatives include a UK law of 2010 that bans creditor lawsuits against poor developing countries undergoing debt relief. Similar legislation has been implemented in Belgium and some other states.

[124] John A. E. Pottow. "Mitigating the Problem of Vulture Holdout: International Certification Boards for Sovereign-Debt Restructurings." *Texas International Law Journal*, vol.49, no. 219, 234–41 (2014).

CHAPTER V: CLAUSES WHICH CAN PREVENT FRIVOLOUS CLAIMS OVER SOVEREIGN DEBT RESTRUCTURING

Many suggestions have been provided for solving the dilemma between investor interest in the restructuring process and sovereign economy recovery. But they only concentrate on the bondholders' protection and widespread arbitration lead to serious negative outcomes, such as the vulture fund problem, presented in the previous chapter. Many BITs have special clauses dealing with sovereign debt restructuring. Moreover, some recent BITs contain guidelines for the interaction between sovereign debt restructuring and the BIT concerned, usually in the form of a special provision or an annex on public debt.[125]

This Chapter proposes several clauses which can prevent frivolous claims over sovereign debt restructuring based on the above legal and economic analyses of the results of previous disputes between defaulting states and holdout creditors. The risk of holdout litigation largely depends on how investment agreements (mainly BITs) and particular debt contracts (bonds) are written. The development of a legal framework prevent frivolous claims can be better achieved by inclusion of collective action clauses into sovereign bonds (which is already done by EU-members in a legislative manner), and paying greater attention to the choice of law and forum, as well as possible waiver of immunity. As to the bilateral investment agreements, more cautious approach is

[125] For example Peru-Singapore FTA (2008), Art. 10.18 "Public Debt", United States-Uruguay BIT (2005), Annex G "Sovereign Debt Restructuring"; Central America-Dominican Republic-United States FTA (2004), Annex 10-A "Public Debt"; Chile-United States FTA (2003), Annex 10-B "Public Debt Chile"; China-Peru FTA, Chapter 10, Annex 8 "Public Debt".

required for drafting of the definitions (investment, territorial nexus etc.) and umbrella clauses.

5.1. BIT Clauses related to the Debt Restructuring

As presented in Chapter III, ISDS mechanism does not exist in a vacuum, but rather serves as an enforcement tool for substantive commitments undertaken by states in investment agreements. Provisions defining the general scope of the investment protection, as well as those setting out specific jurisdictional requirements, dictate when ISDS can deal with holdout creditors' claims over sovereign debt restructuring. It is, therefore, critically important to thoroughly assess and improve the content of BITs with a view to clarifying key concepts and provisions, carefully defining the scope of the treaty protection, and including necessary exceptions.

5.1.1. Dispute Resolution Clause and Overlapping Jurisdiction

The issue of application of ISDS mechanism under the investment treaties has been one of the most debated topics in international investment law over the last decade. In particular, the debate has focused on whether the jurisdiction of an arbitral tribunal is limited to addressing breaches of substantive provisions of the treaty or whether the jurisdiction can be extended to address claims arising from breaches of an investment

contract, bond contract for example. This question still remains unsettled in ISDS jurisprudence.[126]

The difference between the treaty claims and contract claims lies in the cause of action. In Compañía del Aguas del Aconquija, S.A.& Compagnie Générale des Eaux v. Argentina (2002) both the arbitral tribunal and the ad hoc committee with respect to annulment of the award distinguished between claims based on the breach of the applicable investment treaty – the BIT between France and Argentina – and claims based on the contract breach. In this regard, the ad hoc committee pointed out that a breach of a contract and a breach of the treaty entailed independent standards and state may breach a treaty without breaching a contract, and vice versa:

> "*… whether there has been a breach of the BIT and whether there has been a breach of the contract are different questions*"[127]

The distinction between treaty-based claims and contract-based claims has also been upheld in numerous other cases, such as in Lanco International Inc. v. The Argentine Republic (1998) and CMS Gas Transmission Company v. The Republic of Argentina (2003) among others. Meanwhile, there are two approaches to the determination of the scope of application of ISDS mechanism.[128] Under the first, a treaty-based arbitral tribunal has jurisdiction over mere contractual claims when the dispute resolution clause is drafted in sufficiently broad language to extend to "*any*

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[126] Gaillard, E. "Treaty-based jurisdiction: Broad dispute resolution clauses", *New York Law Journal*, Vol. 234, No. 68, p. 1–3.
[127] *Eqorcº¶c"fgn"Ciwcu"fgn"Ceqpswklc."U0C0("Eqorcip*
ICSID Case No. ARB/97/3, Annulment Tribunal, Decision on Annulment (3 July 2002), paras. 95-96.
[128] Ibid. 126, p. 1–3.

dispute between a Contracting Party and an investor of the other Party". For example, Article 8.1 of the BIT between India and South Korea (1996) states that the BIT will cover:

> "*<u>Any dispute</u> between a Contracting Party and an investor of the other Contracting Party <u>relating to an investment</u> o c f g " w p f g t " v j k u " C i t g g o g*[129] (emphasis added)

One of the first decisions to address this question was the decision on jurisdiction handed down in 2001 by <u>Salini Construtorri S.P.A. v. Morocco</u> (2001). The dispute resolution clause of the applicable BIT in that case was “very general”, drafted similarly to the clause from India-Korea BIT, presented above. Accordingly, the tribunal held that :

> “*…the reference to expropriation and nationalization measures í <u>cannot be interpreted to exclude a claim based in contract</u> from the scope of application of this Article*”[130] (emphasis added)

The better approach from the sovereign’s point of view is to carefully draft the dispute resolution clauses in the investment treaty in order to provide that ISDS mechanisms shall apply only to those disputes that are related to a covered investment and a breach of this particular treaty. Some treaties expressly restrict the jurisdiction of the treaty-based tribunal to breaches of the substantive standards contained in the treaty and that the dispute should arise "*in connection with*" an investment, "*arising out*" of an investment, "*with respect to*" an investment, "*concerning*" an investment or "*related to*"

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[129] Agreement between the Government of the Republic of India and the Government of the Republic of Korea on the Promotion and Protection of Investment, New Delhi, 26 February 1996.
[130] Ibid. 54, para. 59.

an investment.[131] For example, Article 15.1 of the trilateral investment agreement between Japan, Republic of Korea and China (2012) provides that:

> *" í " k p x g u v o g p v " f k u r w v g " k u " c " f k u r w v g " d g v y g g p*
> *of another Contracting Party that has incurred loss or damage í* *arising out of*
> *c p " c n n g i g f " d t g c e j " q h " c p { "* *with respect to the* *k q p " í " w p f*
> *investor or its investments* *in the territory of the former Contracting Party.* "[132]
> (emphasis added)

Thus, the wording "*any dispute with respect to investments*" may be contrasted with that of other dispute resolution provisions which limit the scope of the arbitration to disputes. In order to prevent frivolous claims by bondholder, which arise solely from the alleged breach of bond contract, the sovereigns should pay more attention to the language of the dispute resolution clause in the negotiated investment treaty.

However, even in case the ISDS clause is drafted recognizing the difference between treaty claims and contract claims it does not mean that an arbitral tribunal never has jurisdiction over claims arising under a contract. This leads us to the next specific clause in the BITs, particularly the so-called "umbrella clause".

[131] Ibid. 30.

[132] Agreement among the Government of Japan, the Government of the Republic of Korea and the Government of the People's Republic of China for the Promotion, Facilitation and Protection of Investment, Beijing, 13 May 2012.

5.1.2. Umbrella Clause

Umbrella clause[133] requires a state to respect any kind of obligation with regard to a specific investment, for example, the ones contained in specific investment contract. Thus it brings contractual and other individual obligations of the sovereign under the "umbrella" of the investment treaty, making them potentially enforceable through investor-state dispute resolution system.[134] The tribunal in Consortium Groupement L.E.S.I.–DIPENTA v. Algeria (2005) laid emphasis on the absence of an umbrella clause in the treaty at issue:

> õ í*Certain treaties indeed contain provisions known as observance of w p f g t v c m k p i u " e n c w u g u " q t " ÷ w o d t g n n c " e n c w u g u v t c p u h q t o " d t g c e j g u " q h " v j g " U v c v g ø u " e q p v t c e that provision of the treaty and, accordingly, to endow the arbitral tribunal constituted in accordance with the treaty with jurisdiction over such d t g c e ö j*[135] (emphasis added)

As an example of the umbrella clause, Article 5.2 of the trilateral investment agreement between Japan, Republic of Korea and China (2012) is illustrative, although we have previously praised this particular investment treaty for a careful drafting of the dispute resolution clause:

[133] Umbrella clauses are also are less frequently termed as "observance of undertakings", "mirror effect", "elevator", "parallel effect", "sanctity of contract", "respect clause" and "pacta sunt servanda" provisions.
[134] UNCTAD. Series on Issues in International Investment Agreements II, United Nations, New York and Geneva, 2014, p.165.
[135] Consortium Groupement L.E.S.I.–DIPENTA v. Algeria, ICSID Case No. ARB/03/8, Award (10 January 2005), para. 25.

õ G c e j " E q p v t c e *observe any written commitments in the form of an agreement or contract it may have entered into with regard to investments of* *k p x g u v q t u " q h " c p q v j g t " E q p v t c e v k p i " R c t v { ö*[136] (emphasis added)

This trilateral treaty is not an exception, many model BITs of developed countries include some form of the umbrella clause. For instance, the UK Model BIT provides, in Article 2, that:

õ í each Contracting Party shall observe any obligation it may have entered into with regard to investments of nationals or companies of the other Contracting R c t v ö[137] (emphasis added)

Coupled with an ISDS mechanism, umbrella clauses afford a direct remedy in international law to foreign investors in respect of their sovereign bonds contracts and other legal commitments that a State may have entered into with them or with regard to their investments.[138] The decision in Eureko B.V. v. Republic of Poland (2005), contained a positive exposition of the scope and effect of umbrella clause in the light of Article 31 of the Vienna Convention on the Law of Treaties[139], the Tribunal stated that:

õí cp { ø " q d n k i c v k q p u " k u " e c r c e k q w u = " k v " o g c p u v { r g . " ó that is to say, ôallö ó obligations entered into with regards to k p x g u v o g p v u " q h " k p x g u v q t u " q h " v j g " q v j g t " E q p v[140]

[136] Agreement among the Government of Japan, the Government of the Republic of Korea and the Government of the People's Republic of China for the Promotion, Facilitation and Protection of Investment, Beijing, 13 May 2012.
[137] Ibid. 31.
[138] Anthony C. Sinclair. "The Origins of the Umbrella Clause in the International Law of Investment Protection". *Arbitration International*, Issue 4, (2004), pp. 411–434 .
[139] Vienna Convention on the Law of Treaties (adopted 23 May 1969, entered into force 27 January 1980) UNTS, vol. 1155, p. 331.
[140] Eureko B.V. v. Republic of Poland, Partial Award (19 August 2005), para. 246.

In international legal doctrine it is widely accepted that through the effect of an umbrella clause, a breach of a contract becomes a treaty violation.[141] But, variations in wording of the observance clause from treaty to treaty can yield differences in scope and effect. For example, in Salini CostruttoriS.p.A. and Italstrade S.p.A. v. The Hashemite Kingdom of Jordan (2004) the disputed treaty provision was different from the language of umbrella clauses discussed in other cases and was held not to have any effect. The relevant provision in the Italy-Jordan BIT (2001) provided that:

> *Œach Contracting Party shall create and maintain in its territory a legal framework apt to guarantee to investors the continuity of legal treatment, including the compliance, in good faith, of all undertakings assumed with regard v q " g c e j " u r g e k h k e " k p x g u v q t ö*[142]

It is not an obligation to observe commitments *per se*, or an obligation, which can create international responsibility for breach of such commitments. Although it is estimated that 40% of the BITS include some form of umbrella clauses,[143] bulk of the BITs, as well as the NAFTA Chapter 11 on investment,[144] do not include it at all and this is an option that removes the uncertainty surrounding its meaning and effect. Other treaties add a clarification aimed at excluding the availability of the ISDS mechanism for

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[141] Chrostoph Schreuer. "Investment treaty arbitration and jurisdiction over contract claims: The Vivendi I case considered", in Weiler, T., ed., *International Investment Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law.* London, Cameron May (2005), pp. 291– 324, p. 299.

[142] Agreement between the Government of the Hashemite Kingdom of Jordan and the Government of the Italian Republic on the Promotion and Protection of Investments, Amman, 21 July 1996.

[143] Judith Gill. “Contractual Claims and Bilateral Investment Treaties.” *Journal of International Arbitration*, vol. 5 (2004), pp. 397–412.

[144] Malik Mahnaz. “The Expanding Jurisdiction of Investment State Tribunals: Lessons for Treaty Negotiators”. *Issues in International Investment Law: Background Papers for the Developing Co*w p v t { " K p x g u v o g p . Singapore (October 2007), p.13ø " H q t w o

disputes arising out of a contract when there is a contractually specified dispute settlement provision, as will be discussed later in this Chapter. For example, the Article 19.2 of the Greece-Mexico BIT (2000) provides:

> "… e*ach Contracting Party shall observe any other obligation it may have entered into in writing with regard to a specific investment of an investor of the other Contacting Party.* _*The disputes arising from such obligations shall be settled only under the terms and conditions of the respective contract*_ *í*"[145] (emphasis added)

This subparagraph presented several options for drafting the umbrella clause in order to at least attempt to allocate jurisdiction between international tribunals under the investment treaties and other courts or tribunals under the specific investment contract.

5.1.3. Territorial Nexus

As discussed in Chapter III, contribution to the state's development is one of the subjective requirements for an asset (transaction) to qualify as investment for the purposes of Article 25(1) of the ICSID Convention. The territorial nexus between such contribution and the economy of the host state is a fundamental aspect of the economic materialization of the investment.[146] This requires that there should be at least some physical presence in the territory of the host state. Even though the investment must not

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[145] Agreement between the Government of the United Mexican States and the Government of the Hellenic Republic on the Promotion and Reciprocal Protection of Investments, Mexico City, 30 November 2000.

[146] Zachary Douglas. "Property, Investment and the Scope of Investment Protection Obligations" in Douglas Zachary et. al. *The Foundations of International Investment Law: Bringing Theory into Practice* (2013)

be located therein entirely, a mere flow of capital, however, is insufficient.[147] Thus, the existence of territorial nexus in case of sovereign bonds is highly arguable.

The term "investment" in itself is geographically neutral and the language of Article 25(1) of ICSID Convention and, therefore, is rather inconclusive. But the object and purpose of the ICSID Convention to promote economic development[148] is served best by investments physically present in the territory of the host state. Otherwise, contributions to economic development would be highly unlikely. At the same time, case law shows that it would be particularly odd to exclude certain investments for lack of a territorial link, if they are included in the treaty's definition of "investment", as discussed in Chapter III. If a treaty includes loans and bonds in its definitive clause, it would be unrealistic to require a strict physical presence in the host State.[149] A lot of scholars take this position and present the following paragraph 374 of the tribunal's decision in Abaclat and Others v. Argentine Republic (2011):

> ŏ*With regard to investments of a purely financial nature, the relevant criteria should be where and/or for the benefit of whom the funds are ultimately used, and not the place where the funds were paid out or transferred. Thus, the relevant question is where the invested funds ultimately made available to the Host State and did they support the n c v v g t ÷ u " g e q p q o k e " f g x g n*[150]
> (emphasis added)

But, what is more important in this award on jurisdiction is the very next paragraph 375, which clearly states that there is a requirement of investment's link to the

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[147] Michael Waibel. *Sovereign Defaults before International Courts and Tribunals*. Cambridge: Cambridge University Press, 2011, p. 242; Ibid. 34, para. 73.
[148] Ibid. 42, Preamble.
[149] Ibid. 43, para. 197/198.
[150] Ibid. 34, para. 374.

project, enterprise or operation physically situated in the host state. Accordingly, the only possible way for sovereign bonds to fall under ICSID's jurisdiction is when a BIT (Italy-Argentina in this case) includes "bonds" in the list of protected investments.[151]

> *õ í k'v"ku"pgeguuct{"vjcv"kpxguvogpv"í"dg"hw* *enterprise or operation taking place in the territory of the Host State0"í"Ctvkeng" 1 BIT Argentina and Italy designated financial instruments as an express kind of investment covered by the BIT and thereby intending to provide such investment with BIT protection, the Tribunal considers that it would be contrary to the DKV÷u"yqtfkpi"cpf"ckov"vq"cvvcej"c"hwtvjg hkpcpekcn"kpxgu*[152] (emphasis added) *pu vtwogpvu0ö*

In other words, the territorial nexus between the contribution of capital, bonds acquisition, and the host state must be direct rather than indirect or consequential.[153] Therefore, for the sovereigns to secure themselves from possible claims of holdout creditors in case of sovereign debt restructuring it is useful to (i) exclude bonds or public debt from the list of investments in the treaty; and/or (ii) include an explicit territorial requirement. The latter can be done in two ways. The first and more popular way is to affect the *ratione maritae* by including the territorial nexus criteria to the definition of "investment", like it is done in Article 1(1) of the 2009 Turkey Model BIT:

> *õVjg"vgto"$kpxguvogpv$"ogcpu"gxgt{"mkpf" activities, acquired for the purpose of establishing lasting economic relations in vjg"vgttkvqt{"qh*[154] (emphasis added) *Eqpvtcevkpi"Rctv{í*

[151] Footnote 34 and related text.
[152] Ibid. 34, para.375.
[153] Ibid. 146.
[154] Ibid. 40.

The second way is to affect the *ratione personae* by including the territorial nexus criteria to the definition of "investor", like it is done in Article 1 of 2012 US Model BIT, which provides that:

> *õ í " k p x g u v q means a Party or state enterprise thereof, or a national or an enterprise of a Party, that attempts to make, is making, or has made an investment <u>in the territory of the other Party</u> í ő*[155]

Sovereigns can use one of the proposed approaches, or even combine them in cases when bonds or public debt are not explicitly included in the list of covered investments. Then the arbitral tribunals will find that they have no jurisdiction over such debt instruments due to the obvious lack of territorial nexus to the host state.

5.2. Clauses contained in Sovereign Bonds

Tribunal's jurisdiction over sovereign debt depends not only on the applicable investment agreement, but also on the text of the bond contracts themselves. They are drafted by lawyers at major global firms, involve transactions worth millions of dollars, and in the modern era are actively traded by sophisticated players in secondary markets, such as vulture funds discussed above. Thus, it is tempting to believe that the terms of the bond contracts represent optimal solutions to the problems that concern the market. Like other boilerplate contracts, sovereign bonds rarely adopt new terms.[156] But the resolution of sovereign debt defaults is a complex process. For instance the last

[155] Ibid. 33.
[156] Ibid. 112, p. 132–33.

Argentine default took four years to settle and over 140 lawsuits were filed against the sovereign. In order to lessen these problems, proposals to modify the terms of international sovereign bond contracts has received greater attention.

5.2.1. Forum Selection Clause

A common clause in most international contracts is the jurisdiction clause, which is different from choice of law clause and seeks to provide a court located in a specific location with the power to resolve a dispute. Thus, parties to a bond contract agree which country's or countries' courts are to have "jurisdiction" (legal authority) to hear disputes arising from the bonds. This clause may take non-exclusive and exclusive form.

In case of non-exclusive jurisdiction more than one court may take jurisdiction over the case. The following two examples (Turkey and Argentina bonds) are a typical formulation of a non-exclusive domestic jurisdiction clause in a sovereign bond governed by New York law.

> *õ íany state or federal court in the City of New York or in any competent court in Turkey 0 ö*[157]

> *õ íArgentina has irrevocably submitted to the jurisdiction of U.S. state or federal court sitting in the Borough of Manhattan, the City of New York í , the courts of England í , and the courts of Argentina í ö*[158]

[157] Ibid. 85.
[158] The Republic of Argentina, Prospectus Supplement for USD 81.8 billion (Jan. 10, 2005)

Clauses drafted in this way confer non-exclusive jurisdiction on several courts and do not include the wording “*exclusive jurisdiction*” or “ *g z e n w u k x g n { "" v q " v j g " e q*
Therefore, such clauses by placing these sovereign bonds firmly in the ambit of New York and other courts, do not as such bar the ICSID tribunals’ jurisdiction.

On the opposite, exclusive jurisdiction exists where one court has the power to decide on a dispute to the exclusion of all other courts. Below is an exclusive jurisdiction clause in French bonds contract, which can be occasionally found in some other sovereign bonds.

> *õ ïThe Issuer submits to the* <u>*exclusive jurisdiction*</u> *of the competent courts in Paris. ö*[159] (emphasis added)

This type of forum selection clause excludes jurisdiction by “any other venue”, a list of several possible courts and includes the “exclusive” wording. Would the clause drafted in such a way bar an ICSID (or other international) tribunal from hearing treaty and contractual claims? Case law presents that the tribunal should not exercise its jurisdiction over a claim when the parties have already agreed on how such a claim is to be resolved, and have done so exclusively.[160] Contractual forum selection clause is *lex specialis* and, therefore, overrides treaty arrangements, on the basis of the principles of *generalia specialibus non derogant*.[161] No hierarchy exists between the bond contract and investment treaty forum selection clauses. Extending the preclusive effect of

[159] France, Prospectus for Euro 0.5 billion of 3.125% Bonds Due (Jan. 17, 2014).
[160] SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan, ICSID No. ARB/01/13, Decision of the Tribunal on Objections to Jurisdiction (6 August 2003), para. 70.
[161] Southern Pacific Properties (Middle East) Ltd. v. Arab Republic of Egypt, ICSID Case No. ARB/84/3, Decision on Jurisdiction (27 November 1985), para. 83; Ibid. 43, p.362.

exclusive jurisdictional clauses in sovereign debt instruments to treaty causes of action preserves the unity of the contractual bargain.[162] If, in case of an exclusive jurisdiction clause in the bond creditors request arbitration, they are then pleading the breach of one term of the contract, while not observing another.[163]

In such circumstances, the exclusive forum selection clause contained in the bond contract will preclude the frivolous claims over the debt restructuring and constitute a bar to the jurisdiction of ICSID tribunal or any other venue.

5.2.2. Collective Action Mechanism

As presented in Chapter IV of this paper, even if the majority of creditors agree to a proposed sovereign debt restructuring, individual creditors may be incentivized to hold out. After long discussions during the early 2000s, it was decided to rely upon a contractual approach to address these collective action problems; namely, the promotion of collective action clauses (CACs). [164] It allows a qualified super-majority of bondholders a specific bond (typically 75%) to agree on a revision to the bond terms that is binding on all, even those who hold out, making it more difficult for the vulture funds to block a restructuring. An additional feature of most CACs is the additional "majority enforcement" provision, which limits the ability of a minority holdouts to enforce their

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[162] Zachary Douglas. "The hybrid foundations of investment treaty arbitration". *British Yearbook of International Law*, vol. 74 (2003), pp. 152–284, p. 243.
[163] Ibid. 147, p.262.
[164] Ibid. 8, p.15-16; Törbjörn I. Becker, Anthony J. Richards and Yunyong Thaicharoen. *Bond restructuring and moral hazard: are collective action clauses costly?* IMF working paper (No. 01/92), 1 August 2001, p.3.

claims following a sovereign default. These provisions typically require 25 % of the bondholders of a given series to accelerate their claims.[165]

The possibility of use of CACs for sovereigns had been first raised in 1995. It has since been widely discussed and used by a number of international groups including the G-7, G-10 and G-22. Key turning point in the history of collective action clauses is Mexico's 2003 bond issuance.[166] Part of the story is that Mexico's status as a Latina America market leader was crucial to the shift in bonds clauses. Moreover, the U.S. Treasury explicitly endorsed this initiative in 2002, launching a behind-the-scenes campaign, exhorting, educating, and arm-twisting in an effort to promote the use of these or competing model CACs in Mexican sovereign bonds.[167] In February 2003, this policy idea became reality and Mexico issued $1 billion bonds in the New York market,[168] which contained the following CAC clause:

> *õV j g " f g d v " u g e w t k v k g u " y k n n " e q p v c k p " õ e q n n g e*
> *indicated in the applicable prospectus supplement. Under these provisions,*
> *y j k e j " f k h h g t " h t q o " v j g " v g t o u " q h " O g z k e q ø u "*
> *prior to March 2003, Mexico may amend the payment provisions of the debt securities with the consent of the holders of 75% of the aggregate principal amount of the outstanding debt securities. ö*[169] (emphasis added)

Other countries quickly followed suit. For example, the EU Member States agreed in April 2003 to include collective action clauses in their sovereign bond

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[165] Ibid. 8, p.16.

[166] Barry Eichengreen. "Restructuring Sovereign Debt." *Journal of Economic Perspective*, vol. 17, no. 75, 77 (2003), p.87.

[167] J.B. Taylor. *Sovereign debt restructuring: A U.S. Perspective*. Remarks at the Institute for International Economics conference on "Sovereign Debt Workouts: Hopes and Hazards", Washington, 2002.

[168] Ibid. 22, p.14.

[169] United Mexican States, Prospectus for USD 40 billion of 5.875% Notes Due 2014 (Dec. 3, 2006)

issuances to promote global efforts for orderly restructurings in the event of sovereign default. The speech by the ECOFIN President in April 2003 announced that:

> *õí the EU will use contractual provisions based on the framework developed by the I 3 2 "in ítheir central government bonds issued under a foreign jurisdiction and/or governed by a foreign law by the end of this year. Thereafter, EU Member States will no longer issue such bonds without any CACs 0ö*[170] (emphasis added)

By the time of the Eurozone economic crisis, nearly a decade had passed since ECOFIN representations, yet much Eurozone outstanding debt still derived from bonds without CACs.[171] After the bailout of Greece, Eurozone finance ministers announced the mandatory inclusion of standardized collective action clauses in all new euro area government issuances. Accordingly, Article 12(3) of the ESM Treaty provides:

> *õCollective action clauses shall be included, as of 1 January 2013, in all new euro area government securities, with maturity above one year, in a way which ensures that t j g k t " n g i c n " k o " k f g p v k e c n 0 ö*[172] (emphasis added)

A standardized CAC has been developed and agreed by the Economic and Financial Committee on 18 November 2011:

> *õThe terms and conditions of the Bonds í may be modified in relation to a reserved matter with the consent of the Issuer and:*
> *(a) the affirmative vote of holders of not less than 75% of the aggregate principal amount of the outstanding Bonds represented at a duly called meeting of Bondholders; or*

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[170] Economic and Financial Committee. *Implementation of the EU commitment on Collective Action Clauses in documentation of International Debt Issuance.* ECOFIN, Brussels, 12 November 2004, p.7.
[171] Gelpern, Anna and Gulati, Mitu. *The Wonder-Clause*. Georgetown Law Faculty Publications and Other Works. paper (No. 1281), 2013.
[172] Treaty Establishing the European Stability Mechanism, Brussels, 2 February 2012.

(b) a written resolution signed by or on behalf of holders of not less than 66 2/3% of the aggregate principal amount of the Bonds then outstanding.[173](emphasis added)

By now, collective action clauses have become the standard market practice. As of June 2014, of the approximately USD 900 billion international government bonds outstanding, about 80% include CACs.[174] Bond contracts with CAC can remove one source of inefficiency and deadweight loss in international financial markets. Moreover, the existence of such restructuring procedures reduces the pressure for the IMF and other official creditors to provide financial assistance to defaulting states. There have been suggestions of bailing-in the private sector to reduce lender moral hazard associated with official lending for a long time till now. Proponents of CACs state that such organized restructuring can benefit creditors as well as borrowers, because the value of restructured bonds is higher than any amount that can be recovered after a messy default. In the words of the Economist:

õ í " r t q u r g e v " q h " c p " q t f g t n { " t g p g i q v k c v k q p "
actually make u q o g " d q p f u " o q t g " c v v t c e v k x g 0 ö[175]

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[173] Euro area Model CAC 2012, http://europa.eu (accessed 17 May 2015).
[174] Ibid. 22, p.17.
[175] Economist. "Sovereign Policy." *Economist Magazine* (February 1999), p. 21.

CHAPTER VI: CONCLUSION

6.1. Summary of findings

High level of indebtedness in developed countries is not a new phenomenon and the magnitude of the overall debt problem facing advanced economies today is difficult to overstate. The level of gross sovereign debt continues to grow steadily year by year. If before the crisis in 2007 the ratio to GDP for G7 countries was 85.2%, after the crisis it became 104.9% and reached the unbelievable figure of 125.9% in 2014. The ratio of sovereign debt in the form of bonds is rising similarly to the level of gross indebtedness.

Sovereign debt, especially in the form of government bonds, is an important way for many states to enhance their economic growth. If appropriately managed, government borrowing can be an essential ingredient for economic development. However, when a state has insufficient assets to serve its debt, a sovereign debt default or restructuring will occur. The most prominent sovereign debt restructuring episodes were for sure Argentina's restructuring in 2005 and Greece in 2012. Argentina restructured over USD 60 million of bonded debt, with a face value reduction of 29.4%. Greek restructuring was far more noticeable and involved USD 261.4 million in bonds and almost led to the collapse of the Euro regime.

Many countries, if not today then the next time around, may need to reschedule, restructure, or even default on their debt. Yet in contrast to the private debtors, there is no bankruptcy procedure, and thus protection, for financially impaired sovereigns,

though such a system has been advocated for since at least the time of Adam Smith. When a state cannot serve its debts, the only recourse is to enter in negotiations with creditors. Unlike the bankruptcy process for private debtors, participation in a sovereign debt restructuring is optional, and creditors may choose to "holdout" by bringing lawsuits in order to obtain judgments. According to IMF, the problem of creditor holdouts and related litigation has been widely seen as the main potential obstacle to timely and efficient bond debt restructurings. The number of litigation cases following a default or restructuring on sovereign debt have notably increased and creditor strategies have become more aggressive.

This paper shows that the regime for effective sovereign debt restructuring is very fragile. Nowadays there are numerous countries that face a risk of a debt crisis, and at some point in the future debt defaults will certainly occur. It is, therefore, important to ensure that investment treaties and international investment law do not prevent debtor nations from conducting debt restructurings in a manner that facilitates economic recovery and development. The tribunals finding that they have jurisdiction over the holdouts' claims, and therefore, that the scope of investment treaties and sovereign debt restructuring may overlap will open a window for disappointed bondholders all over the world to initiate legal proceedings under international arbitration and therefore undermine the ability of nations to recover from financial crises and thus broaden the impact of such crises, not only for particular state, but for the world economy as a whole. Therefore, courts' and tribunals' decisions related to Argentina's bond restructuring are seen as the ones that are "opening Pandora's box".

6.2. Policy implications

Many suggestions have been provided for solving the dilemma between investor interest in the restructuring process and sovereign economy recovery. But they only concentrate on the bondholders' protection and widespread arbitration lead to serious negative outcomes, such as the vulture fund problem. A statutory sovereign bankruptcy regime is the most obvious response to the current situation. It would provide a crisis management framework and reduce the economic cost of debt restructuring. Procedures of this type have been periodically debated, but so far rejected, and even if the discussions on international level continue, possible insolvency convention would inevitably involve long and complicated negotiations. Therefore, states should pay more attention to the contractual approach to the development of sovereign debt restructuring system.

The risk of holdout litigation largely depends on how investment agreements (mainly BITs) and particular debt contracts (bonds) are written. States should be careful when negotiating its investment treaties and bond contracts and attentive to wording of provisions in order to avoid risk of broad interpretation. The following is a handful of policy remedies, discussed in this paper, which would grant nations the space to conduct effective sovereign debt restructurings and prevent frivolous claims by holdout creditors in the future:

(i) Explicitly exclude "sovereign bonds", "public debt" or portfolio investments as a whole from the scope of BIT protection;

(ii) Draft the dispute resolution clauses in such way to provide that ISDS mechanisms shall apply only to those disputes that are related to a covered investment and a breach of this particular treaty, and not to the breach of bond contract;

(iii) Not include umbrella clause at all to remove the uncertainty surrounding its meaning and effect, or add a clarification excluding the disputes arising out of a contract when there is a contractually specified dispute settlement provision;

(iv) Include an explicit territorial nexus requirement to the definition of “investment” or “investor”;

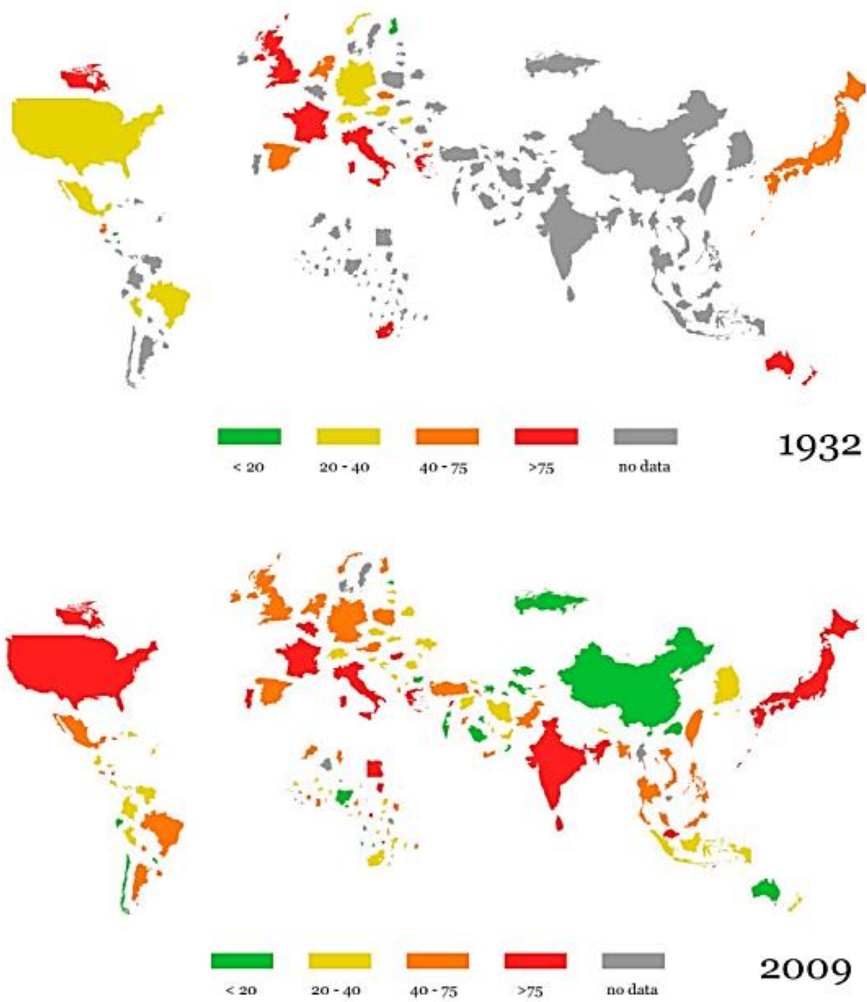
(v) Compose and exclusive forum selection clause in the bond contract to bar to the jurisdiction of ICSID tribunal or any other venue;

(vi) Incorporate collective action mechanism into the bonds, making it more difficult for the vulture funds to block a restructuring.

This list of reforms and clauses proposed in this paper for the new debt instruments and renegotiated investment treaties, is by no means a final one, nor is this paper the end of discussion on this subject.

APPENDIX

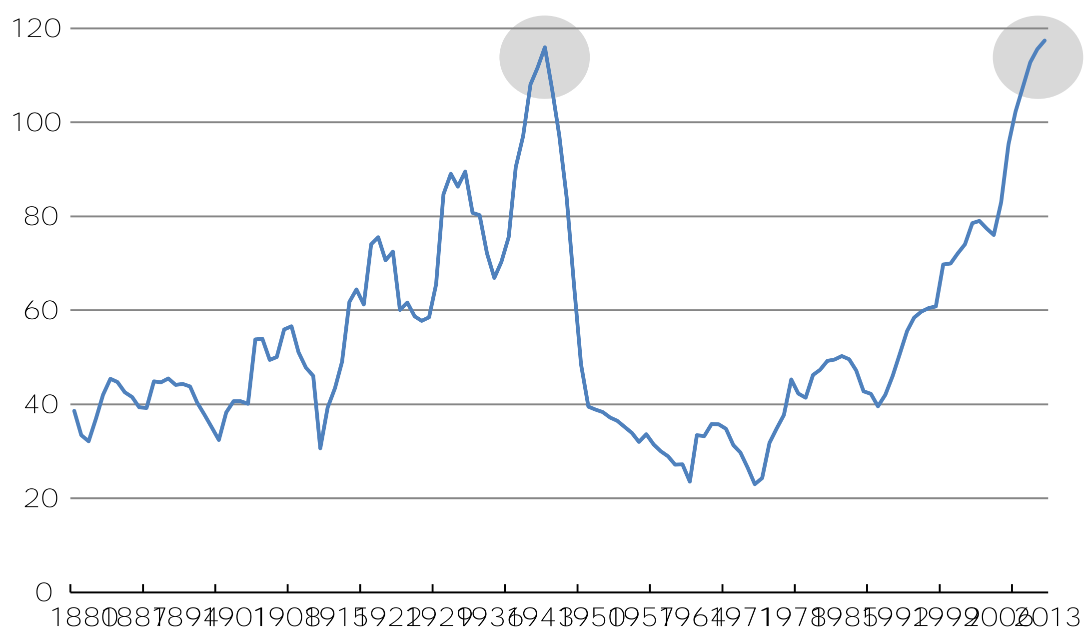
Figure 1. A Tale of Two Crises: The Great Depression (1932) and the Global Financial Crises (2009)



*Color-coding represents Debt-to-GPD ratios

Source: IMF Historical public debt database

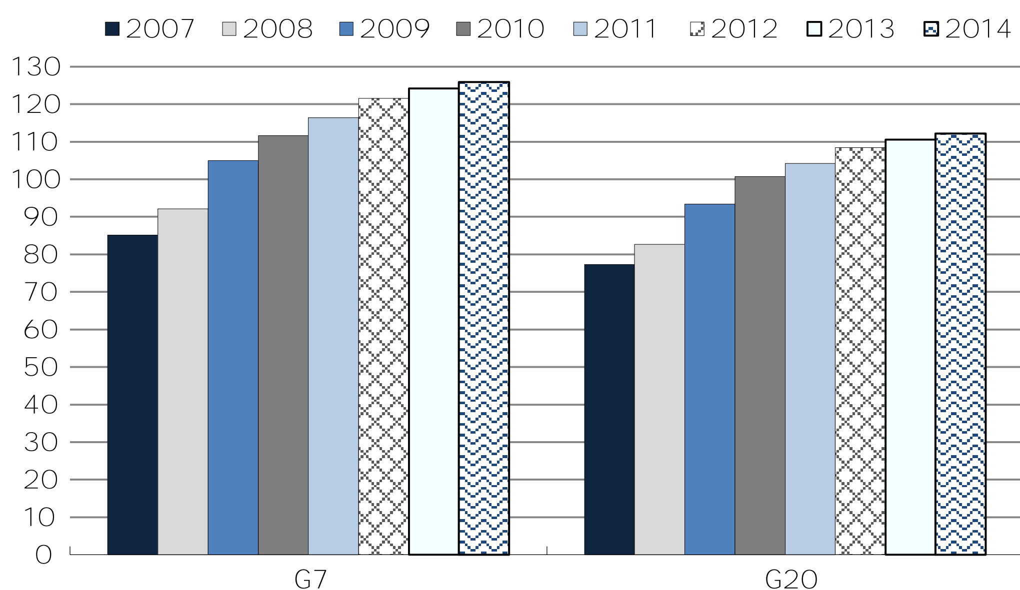
Figure 2. Gross public debt of selected* advanced economies: 1880-2014



* Includes Australia, Canada, France, Germany, Italy, Japan, Korea, Spain, United Kingdom and United States.

Source: IMF Historical public debt database, OECD Economic Outlook 94 database, and OECD staff calculations

Figure 3. Gross government debt for different country groupings, 2007-2014

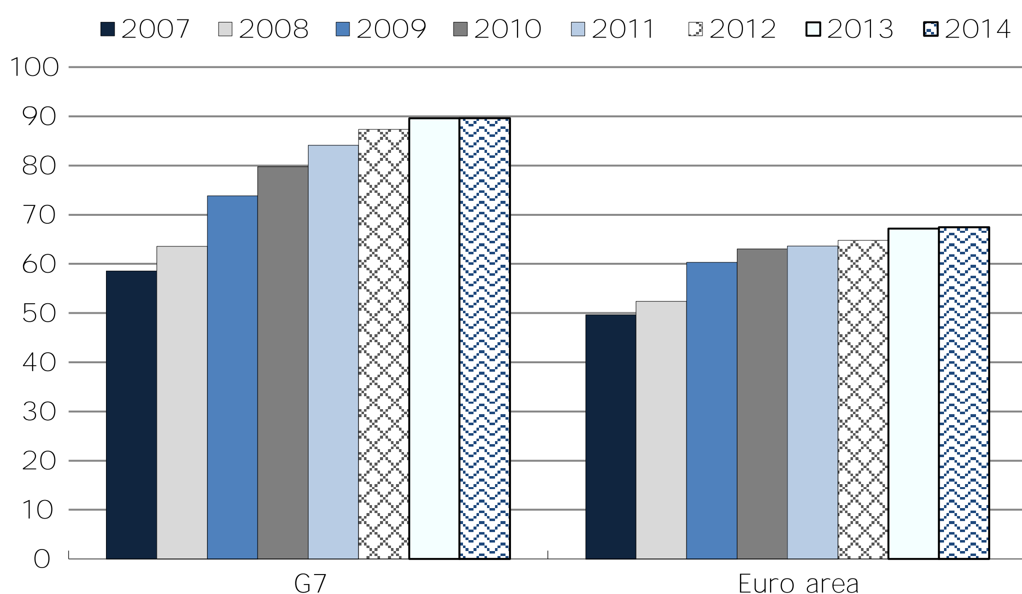


% to GDP	2007	2008	2009	2010	2011	2012	2013	2014
G7	85.2	92.1	104.9	111.7	116.4	121.6	124.2	125.9
G20	77.3	82.7	93.4	100.7	104.2	108.4	110.6	112.2

Note: G-20 includes Argentina, Australia, Brazil, Canada, China, India, Indonesia, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, United States and selected governments of the European Union

Source: OECD Economic Outlook 94 database, IMF World Economic Outlook Database; and OECD staff calculations

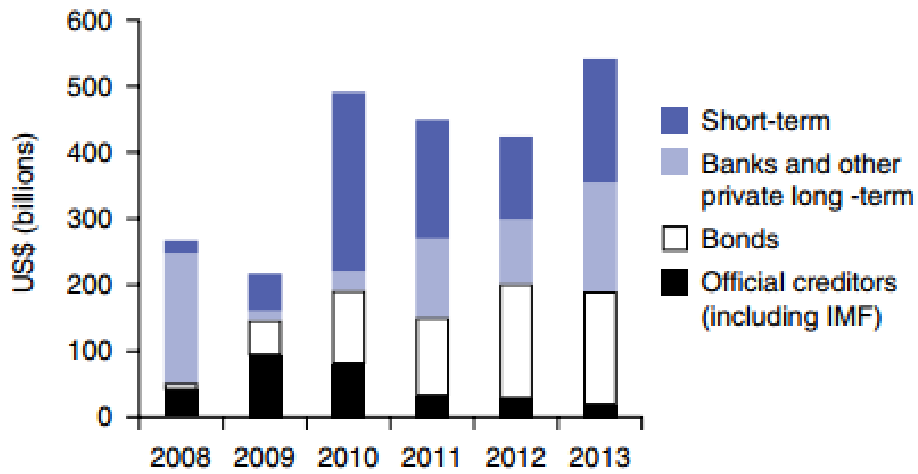
Figure 4. Government marketable debt in OECD countries, 2007-2014



% to GDP	2007	2008	2009	2010	2011	2012	2013	2014
G7	58.5	63.6	73.8	79.8	84.1	87.3	89.6	89.6
Euro area	49.7	52.4	60.3	63.0	63.6	64.8	67.2	67.4

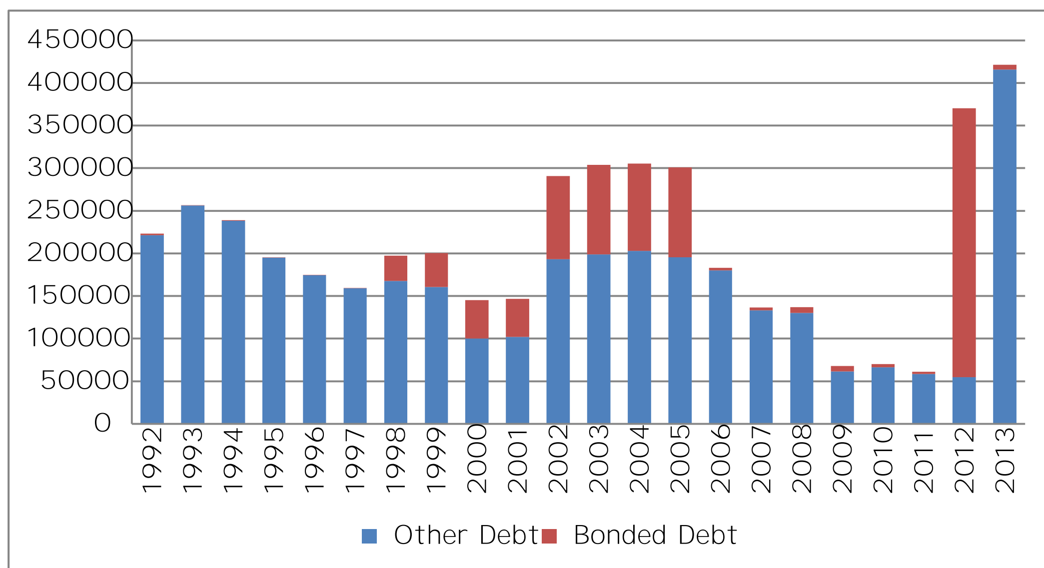
Source: 2013 Survey on central government marketable debt and borrowing by OECD Working Party on Debt Management

Figure 5. Net debt flows to developing countries, 2008 â2013



Source: World Bank. International Debt Statistics 2015

Figure 6. Total Debt in Default (USD million)



Source of data: Bank of Canada. Credit Rating Assessment Group

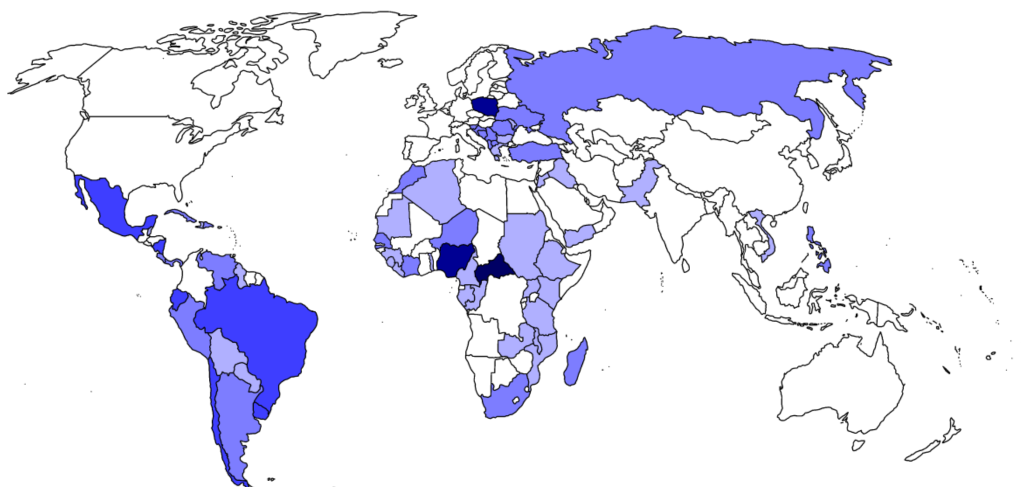
Table 1. Global Rankings by Cumulative Probability of Default

Country	CPD (%)	Bonded debt (UDS billions)	# of BITs in force
Argentina	Defaulted[176]	595.8	66
Venezuela	65.8%	54.7	31
Ukraine	59.0%	20.4	59
Pakistan	40.1%	4.6	31
Greece	38.7%	176.0	89
Cyprus	27.8%	9.4	71
El Salvador	26.3%	5.6	25
Lebanon	23.4%	37.0	46
Iraq	22.6%	2.7	5
Tunisia	18.0%	3.7	41
Serbia	17.8%	0*	46
Costa Rica	17.8%	3.3	27
Egypt	17.6%	3.8	83
Croatia	17.2%	15.6	98
Vietnam	17.1%	69.6	20
Nigeria	17.0%	2.1	59
Russia	16.2%	245.7	61
Guatemala	15.3%	1.73	24
Indonesia	14.3%	36.2	59
Portugal	14.2%	28.4	92
Turkey	13.9%	101.5	24
South Africa	13.2%	12.2	84
Dubai	12.2%	78.5**	38**
Brazil	11.9%	313.1	13
Hungary	11.8%	39.6	106
All		**1,861.23**	**1,298 (A52)**

Source of data: Global Sovereign Credit Risk Report, Q3 2014; BIS and UNCTAD Database
* No data available
** For UAE

[176] Rated as 'SD' by Standard & Poor's, meaning that the obligor has selectively defaulted on a specific issue or class of obligations

Figure 7. Restructuring events with private creditors



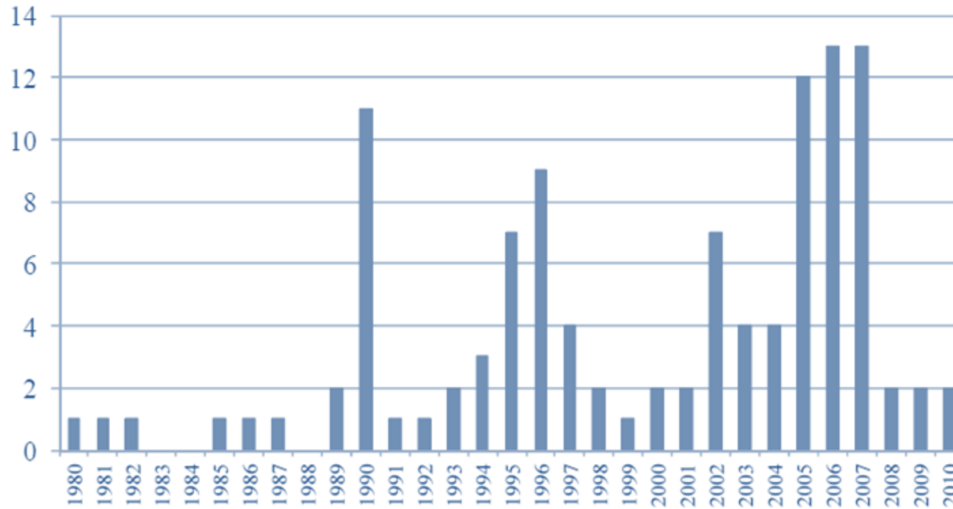
Source of data: Cruces, Juan J. and Trebesch, Christoph, Sovereign Defaults: The Price of Haircuts. American Economic Journal: Macroeconomics 2013, 5(3): 85–117. Available at http://dx.doi.org/10.1257/mac.5.3.85

Table 2. Bonded debt restructuring between 1970 and 2013

Country / Case	Date	Debt Restructured (USD million)	Face Value Reduction
Panama	08 / 1994	452	N
Ukraine (OVDPs, non-resid.)	09 / 1998	420	N
Russia (GKOs, non-resid.)	05 / 1999	4,933	21.0%
Pakistan (Bond debt)	12 / 1999	610	N
Russia (MinFin3)	02 / 2000	1,307	N
Ukraine (Global Exchange)	04 / 2000	1,598	0.9%
Ecuador	08 / 2000	6,700	33.9%
Russia (PRINs & IANs)	08 / 2000	31,943	36.4%
Moldova (Eurobonds)	10 / 2002	40	N
Uruguay	05 / 2003	3,127	N
Dominica	09 / 2004	144	15.0%
Dom. Rep. (Bond debt)	05 / 2005	1,100	N
Argentina (Global)	06 / 2005	60,572	29.4%
Grenada	11 / 2005	210	N
Belize	02 / 2007	516	N
Ecuador	06 / 2009	3,190	68.6%
Seychelles	02 / 2010	320	50.0%
Cote d'Ivoire	04 / 2010	2,940	20.0%
St. Kitts and Nevis	02 / 2012	147	31.8%
Greece *	03 / 2012	261,410	53.5%
Cote d'Ivoire	10 / 2012	2,711	3.8%
Belize	02 / 2013	586	10.0%

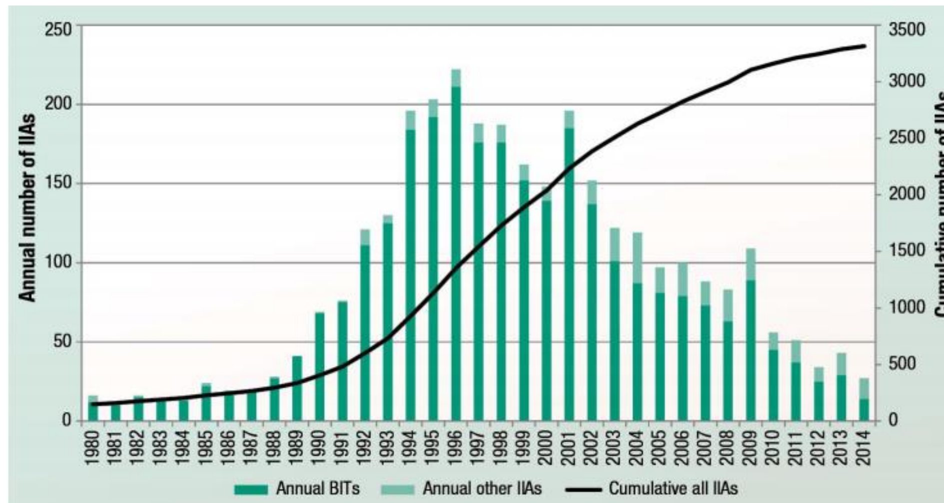
Source of data: Cruces, Juan J. and Trebesch, Christoph, Sovereign Defaults: The Price of Haircuts. American Economic Journal: Macroeconomics 2013, 5(3): 85–117. Available at http://dx.doi.org/10.1257/mac.5.3.85

Figure 8. Litigation against sovereigns, cases filed per year, 1980-2010



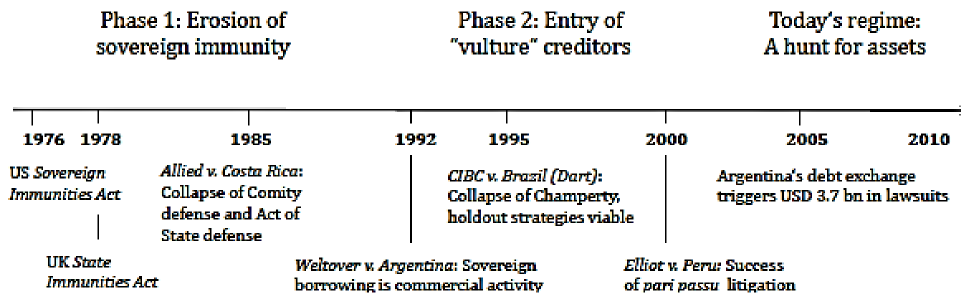
Source: Enderlein, Henrik, Julian Schumacher and Christoph Trebesch. *Explaining Creditor Litigation in Sovereign Debt Crises*. Unpublished Paper. Hertie School of Governance. 2011.

Figure 9. Trends in IIAs signed, 1980-2014



Source: World Investment Report 2014, UNCTAD IIA issue note

Figure 10. Evolution of Litigation Environment



Source: Julian Schumacher, Christoph Trebesch and Enderlein, Henrik. *Sovereign Defaults in Court*. Free University Berlin/Hertie School, May 6, 2014.

Figure 11. Greece Timeline

Source: Olivet, Cecilia and Pia Eberhardt. *Profiting from Crisis: How corporations and lawyers are scavenging p t q h k v u " h t q o " G w t q . r* Amsterdam: *e t k u k u " e q* Transnational Institute and Corporate Europe Observatory, March 2014

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ABSTRACT (KOREAN)

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Key words: , , , ICSID,

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