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SOVEREIGN DEBT RESTRUCTURING AND INTERNATIONAL INVESTMENT AGREEMENTS*

I. Introduction

This Note examines the extent to which international investment agreements (IIAs)[1] may affect the ability of States to implement sovereign debt restructurings when a debtor nation has defaulted or is close to default on its debt. Numerous defaults and restructurings of the 1990s, Argentina's debt restructuring after its crisis in 2001, as well as the recent global financial and economic crisis have all emphasized that governments may need some freedom to maneuver in this area.

While thus far, Argentina is the only nation to be subject to IIA claims related to the nations' sovereign debt default and subsequent restructuring, today's situation where numerous countries face the risk of debt crises, suggests that the prospect of holdouts (i.e. investors who refuse to negotiate and demand that the debt instruments be honored in full) bringing additional investor-State dispute settlement (ISDS) claims cannot be ruled out. It is therefore important to ensure that IIAs do not prevent debtor nations from negotiating debt restructurings in a manner that facilitates economic recovery and development.

Highlights

- Currently, there is no single forum for nations to address issues related to debt. Instead, different policy jurisdictions apply to sovereign debt restructurings (SDRs), with international investment agreements (IIAs) being one of them.
- Where public debt obligations are covered by an IIA, bondholders may use investor-State dispute settlement (ISDS) to pursue their financial interests – evidenced by the case of Argentina that was subject to IIA claims related to the nations' sovereign debt default and subsequent restructuring.
- As it cannot be ruled out that a public debt restructuring would breach a provision of the IIA, such as national treatment, expropriation, or fair and equitable treatment, some more recent IIAs specifically address the interaction between SDRs and the IIA.

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[1] "IIA" in this Note refers to any international treaty with investment provisions, including bilateral investment treaties (BITs) and other IIAs such as free trade agreements (FTAs) or economic partnership agreements (EPAs).

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II. Debt, Development and Financial Crises

Government borrowing through sovereign bonds is a long-established feature of the world economy. However, in financial crises, governments may face problems in servicing their sovereign debt and may eventually find themselves defaulting on their sovereign debt commitments. Previous sovereign default events have occurred in least-developed, developing and developed countries alike.

A. Lack of a single international regime for debt restructuring

When a government is no longer able to pay its debts, sovereign debt restructurings (SDRs) usually follow. An SDR is a change to debt contracts that is negotiated between creditors and the debtor State. SDRs, or “workouts”, often take the form of reducing the face value of the debt or “swaps” where new bonds with lower interest rates and longer maturities are exchanged for the defaulted bonds. Such workouts are usually highly discounted and result in a loss for bondholders. Losses to creditors, through reduction in the principal amount, changes in interest rates, or extended payment terms, are commonly referred to as “haircuts”.

Currently there is no single comprehensive regime or adequate forum for nations to “workout” their debt problems. At the international level, certain classes of lenders are coordinated through “clubs” – the Paris Club comprising rich-country government lenders, and the London Club, which brings together commercial-bank lenders. However, in the past decades there has been a growing amount of sovereign debt held by numerous creditors dispersed around the globe. This has created a new class of creditors, making the restructuring process more complex.[2]

When it comes to restructuring government debt, the standard practice in the past two decades has been for a government, after taking market soundings, to make an exchange offer in the expectation of securing the acceptance of a great majority of creditors. There are always some “holdouts”, i.e. investors who refuse to negotiate and demand that the debt instruments be honored in full. Holdouts may be “vulture funds”, which have purchased debt at low prices, driven down by payment problems. By accumulating a large amount of bonds, they can justify the high costs of litigation (Wells, 2010).

Holdouts seek to obtain preferential financial terms for themselves, as compared to the majority of creditors. They can thereby obstruct a restructuring that is in the broader interest. Holdouts may file suits under the domestic laws that govern bond contracts, often outside the debtor State’s territory. In a new development, holdout investors have initiated international arbitral proceedings under IIAs (see box 1). From the claimants’ point of view, one of the advantages of an international arbitral award is that it may offer a higher chance of compliance by the debtor States, as compared to a decision of a foreign court.

B. Recent sovereign debt restructurings

Table 1 lists some of the major SDRs over the last few years. It shows the duration of the SDR negotiations, the total face value of the bonds under restructuring, the “haircut” and participation rate (i.e. the percentage of investors accepting the ”haircut”).

The most recent restructurings have occurred in Argentina, culminating in 2010. Some of the holdouts in Argentina’s restructurings have brought claims to ICSID under IIAs. A synopsis of the Argentina case is presented in box 1.

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[2] The lack of a single international regime to manage all of a country’s foreign obligations in times of crisis stands in contrast to the bankruptcy process available for private debtors in trouble. In dealing with the problems of private firms, the coordination offered by bankruptcy is considered to be in the common interest. Domestic bankruptcy regimes can halt the rush of creditors to seize assets before others get them and they determine priorities for various categories of claimants. Also, they can force holdouts to agree to fairly distributed reductions in obligations and try to maximize the benefit available to creditors as a group. Restructuring and reducing obligations allows the bankrupt entity to return to a growth pattern (Wells, 2010).

Table 1. Sovereign Debt Restructurings, 1998 to 2010

	Duration (m)	Value (US $ billion)	Haircut (%)	Participation (%)
Russia (1998-2000)	20	31.8	37.5	98
Ukraine (1998-2000)	3	3.3	0.0	95
Pakistan (1999)	10	0.6	0.0	95
Ecuador (2000)	12	6.8	40.0	97
Uruguay (2004)	1	5.4	0.0	93
Argentina (2005)	40	81.8	67.0	76
Argentina (2010)	60	18.0	75	66
Argentina total	100	99.8		93

Sources: Porzecanski (2005); (Dhillon et al., 2006); (Hornbeck, 2010).

Box 1. The Case of Argentina: Crisis, Default, Restructuring and IIA Claims

Having defaulted on its debt in December 2001 as a result of the country's financial crisis, Argentina restructured around US$100 billion of debt by 2010. After the first unsuccessful attempts to restructure, Argentina announced that it would open a one-time bond exchange and passed domestic legislation that it would never hold a future swap with a better offer. In January 2005, the country opened an exchange on over US$100 billion in principal and interest on a diverse number of bond issuances whereby the bondholders were to receive a 67% haircut. It managed to restructure just over US$62 billion, with a considerable participation rate.

Some holdouts, among them numerous vulture funds, took the litigation route in the United States, where 158 suits have been filed (Hornbeck, 2010). For the first time ever, a number of holdouts filed claims under IIAs to the International Center for the Settlement of Investment Disputes (ICSID). In September 2006, approximately 180,000 bondholders initiated arbitral proceeding under the Italy-Argentina BIT for approximately US$3.6 billion.[a] The creditors claim that the Argentine restructuring was tantamount to expropriation and violated fair and equitable treatment standards under the treaty.

Argentina, still left with a significant debt load, launched another exchange from May-June 2010 for US$18 billion of its debt, offering a 75% haircut under the same rationale as in 2005. 66% of the bondholders (US$ 12.1 billion) tendered. $6.2 billion worth of bondholders will continue to litigate either through domestic courts or through ICSID. Since then, some of the Italian bondholders who have filed an ICSID claim did tender, although approximately US$ 1 billion worth of ICSID claims remain.

[a] Giovanna a Beccara and others v. Argentine Republic, ICSID Case No. ARB/07/5. See also Giovanni Alemanni and others v. Argentine Republic, ICSID Case No. ARB/07/8, and Giordano Alpi and others v. Argentine Republic, ICSID Case No. ARB/08/9. In all three cases, investors rely on the Argentina-Italy BIT.

III. The Role of International Investment Agreements

The IIA claims against Argentina prompted questions about the extent to which IIAs grant governments the policy space to restructure sovereign debt in a comprehensive, just and efficient manner. This section addresses the issue of coverage of sovereign debt by IIAs, reviews IIA provisions that might provide grounds for international claims and looks at whether IIAs provide sufficient safeguards.

A. Coverage of government bonds by IIAs

An enquiry into the relationship between SDRs and IIAs starts by determining whether a particular IIA applies to government bonds. Most existing IIAs use a broad asset-based definition of investment that covers "every kind of asset" owned or controlled by an investor.

The all-encompassing nature of this definition suggests that it may cover government bonds as well. Some IIAs explicitly include "government-issued securities",[3] or refer to all "bonds, debentures and other debt instruments" and contain a special provision on government debt, thus making clear that the latter is covered.[4]

On the other hand, a number of IIAs explicitly exclude sovereign debt from the treaty coverage.[5] Some treaties exclude portfolio investments in general.[6] Still other IIAs, such as NAFTA, create some uncertainty by expressly excluding debt securities of State enterprises but being silent about government bonds. It is also questionable whether a treaty covers sovereign debt obligations where its definition of investment, while being open-ended, expressly refers only to "debentures in a company" and "claims to money … related to a business."[7] Finally, where an IIA contains a reference to the mandatory characteristics of an investment (usually commitment of capital, the expectation of gain or profit and the assumption of risk),[8] one would need to determine whether public debt securities meet these requirements.

An IIA claim is conceivable only if an indebted government has an IIA in place with the home country of the bondholder. This means that the potential for IIA claims depends *inter alia* on how many IIAs the host country has in place. However, bonds may frequently change hands in the secondary market, and also be structured through intermediate holding companies, providing opportunities for "treaty shopping" in order for an interested bondholder to obtain protection of an available IIA.[9]

B. Potential tensions between SDRs and IIAs' substantive provisions

Where public debt obligations are covered by a specific IIA, there is scope for a discussion on whether a particular public debt restructuring has violated certain IIA obligations. This section briefly considers several possible grounds for finding a breach of IIA provisions.

<u>National treatment</u>. A national treatment claim can occur when domestic bondholders receive better terms during a restructuring than do foreign bondholders. This can be a concern because there may be considerable economic justification for a differential treatment. Some economists have concluded that "the ability to treat domestic and foreign creditors differently is a necessary policy option for governments in a financial crisis" (Gelpern and Setser, 2004, 796).

Giving priority to servicing domestic debt may be necessary so as to revive a domestic financial system, provide liquidity and manage risk during a recovery. Without such measures a banking crisis can ensue where massive outflows of foreign exchange and/or bank runs can occur. In both the Russian and Argentina cases, this argument underlay the more favorable treatment granted to domestic bondholders (Panizza, 2010; Gorbunov, 2010; Gelpern and Setser, 2004; Blustein, 2005; IMF, 2002). There is also a clear rationale to give priority to local bondholders to retain the ability of economic actors to pay wages, salaries and pensions in order to maintain livelihoods, enable domestic demand and avoid mass protest (Gelpern and Setser, 2004; IMF, 2002). Considerations of this kind may or may not affect a tribunal's deliberations of whether domestic and foreign bondholders are "in like circumstances."

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3 Jamaica-Korea BIT (2003), Article 1.

4 See, for example, Peru-Singapore FTA (2008), Articles 10.1(6) and 10.18; United States-Uruguay BIT (2005), Article 1 and Annex G.

5 Canada-Colombia FTA (2008), Article 838, footnote 11; Australia-Chile FTA (2008), Article 10.1(j)(iii); Azerbaijan-Croatia BIT (2007); Chile-Japan FTA (2007), Article 105. The recently revised model BITs of Colombia (2008) and Ghana (2009) exclude sovereign debt.

6 Turkey Model BIT (2009), Article 1(1).

7 ASEAN Comprehensive Investment Agreement (2009), Article 4(c).

8 E.g. Malaysia-Pakistan FTA (2007), Article 88(d).

9 On "treaty shopping" and methods to counteract it, see UNCTAD, *Scope and Definition: A Sequel* (2011).

Expropriation. Sovereign debt restructuring or default could be seen as constituting an expropriation, and more specifically, an indirect expropriation. The latter refers to situations where the title to the investment or it's physical integrity are not affected, but its value is destroyed or greatly diminished. An outright default without any additional steps by a government will completely destroy the value of the outstanding bonds, while a debt restructuring is likely to diminish their value considerably. Under a "take-it-or-leave-it" swap arrangement a bondholder has the choice of either losing a bond altogether or accepting a new bond with a (sometimes significant) haircut. Tribunals are likely to employ a "substantial deprivation" test[10] to examine the decrease in the value to determine whether a particular restructuring is expropriatory.

Fair and Equitable Treatment (FET). While the precise content of the FET obligation is a subject of an ongoing debate, it is often interpreted as *inter alia* protecting investors' legitimate expectations, guaranteeing freedom from harassment and coercion, and incorporating fundamental principles of due process.[11]

A concern has been expressed that bond exchanges may violate the FET obligation in and of themselves, despite the fact that exchanges have become standard practice. A restructuring could be viewed as undermining the State's contractual promises and the associated legal framework, thereby destroying investors' legitimate expectations. Furthermore, exchanges could trigger allegations that the process lacks transparency and that it is coercive. The "take-it-or-leave-it" nature of exchanges could be seen as violating due process and not seen as being in good faith, because there are no genuine restructuring negotiations (Waibel, 2007). However, effective negotiations with thousands, sometimes hundreds of thousands, of creditors would be impossible, and in practice a debtor State makes an offer that it hopes would be accepted by a "supermajority" of its creditors.

Umbrella clauses. Under an "umbrella" clause, found in a significant number of IIAs, a host country typically assumes the responsibility to respect other obligations it has entered into with regard to the covered investments. Given that a bond establishes a contractual relationship between the borrower (host government) and the lender (investor), a default or an imposed restructuring might be seen as the host State's breach of its contractual obligation to pay the face value of the bond and interest. By virtue of the umbrella clause, such a contractual breach may turn into a breach of the IIA.

A contentious issue with respect to umbrella clauses has been whether any breach of contract is sufficient for a claim under the IIA to proceed, or whether the breach must result from an exercise of sovereign powers by the government.[12] If this distinction is to be followed, the case of a debt default or restructuring is likely to be seen as a sovereign act. Another debated issue is whether the investor can bring a treaty claim obviating the dispute resolution mechanism included in the contract itself. If the approach of the *SGS v. Philippines* tribunal is to be followed in this respect, an "umbrella clause" claim may be considered inadmissible where the bond contract confers exclusive jurisdiction on a different forum (e.g. domestic courts of a particular State).[13]

Transfer of funds. There may be grounds to allege a violation of the State's obligation to allow the free transfer of investments and returns, where the sovereign debt default or restructuring is supplemented by restrictions on the transfer (in the form of capital or currency controls, a tax on outflows, etc.).

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[10] See "§7.16 The requirement for a substantial deprivation" in Newcombe & Paradell (2009, p. 344). See also Hoffmann (2008) and Paulsson & Douglas (2004).

[11] See further, UNCTAD, *Fair and Equitable Treatment: A Sequel* (forthcoming in 2011).

[12] See Newcombe & Paradell (2009, pp. 466-472).

[13] *SGS Société Générale de Surveillance S.A. v. Philippines*, Decision of the Tribunal on Objections to Jurisdiction, 29 January 2004, paras. 136-155, 169(4). See also Waibel (2007, pp. 734-735).

C. General safeguards preserving governments' freedom of action[14]

Some (not all) IIAs contain provisions permitting States to take measures necessary for the protection of "essential security" or "national security" interests. If read as including economic security, such clauses can prove helpful in defending against bondholders' claims, particularly if such clauses are formulated as self-judging and thus limiting the power of arbitral tribunals reviewing the measure.[15] A relevant question with respect to *non*-self-judging clauses is whether the *terms* of a particular debt restructuring, perhaps most importantly the rate of the "haircut", were necessary and proportionate to protect the State's security. It is also not totally clear whether an "essential security" exception should completely excuse the measure (SDR), or provide only a temporary relief until the economic situation in the country normalizes.

With respect to those IIAs that do not include an "essential security" safeguard, there is scope for an argument that general principles of international law enable States to give precedence to basic duties to its population as a whole over the repayment of monetary obligations to individual creditors. A German judge, in a separate opinion, has affirmed that international law must not be interpreted in a way that would cause, aggravate or prolong a State's inability to discharge its most elementary duties towards its citizens.[16] The necessity defence has been incorporated in the Articles on State Responsibility,[17] although its requirements are difficult to meet.

D. Bonds' collective action clauses and their relationship with IIAs

In recent years, the so-called collective action clauses (CACs) have become a common feature of public debt obligations; they are currently found in more than 90% of newly issued bonds (Helleiner, 2009). CACs were designed to increase the coordination of bondholders and streamline the process of sovereign debt restructuring. CACs have the following key features:

- *collective representation* component where a bondholders' meeting can take place where they exchange views and discuss the default/restructuring;
- *majority restructuring* component that enables a 75% "supermajority" of bondholders to bind all holders within the same bond issue to the terms of restructuring;
- *minumum enforcement* component whereby a minimum of 25% of the bondholders must agree that litigation can be taken.

Given the spread of CACs, a question arises whether they can effectively prevent IIA claims. CACs are not uniform; and the examination of a specific clause would be necessary. However, as a general matter, it would appear that where the majority imposes the terms of restructuring on all bondholders within the bond issue, dissenting bondholders cannot succeed in their IIA claims, given that their contractual rights have been duly modified. A minimum enforcement clause may also be viewed as generally precluding IIA claims if it is interpreted to cover all types of dispute settlement claims.

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[14] Some IIAs may also include additional safeguards that excuse conduct which would otherwise violate a *specific* treaty obligation. Thus, with respect to expropriation, a number of IIAs provide that a State's non-discriminatory regulatory actions for the protection of legitimate public welfare objectives should not be seen as expropriatory; in many IIAs the obligation to allow free transfer of funds is qualified by a balance-of-payment exception. However, these safeguards do not apply to the totality of the treaty.

[15] For example, the 2004 United States Model BIT provides: "Nothing in this Treaty shall be construed […] to preclude a Party from applying measures that *it considers* necessary for the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests" (Article 18, emphasis added). The words "it considers" suggest that the host nation should be the judge of whether or not the measure at issue was necessary to protect its security.

[16] See Decision of the German Constitutional Court (the "Bundesverfassungsgericht") of 8 May 2007, Separate Opinion of Judge Lübbe-Wolff, paras.80-93.

[17] Article 25 of the International Law Commission's Articles on the Responsibility of States for Internationally Wrongful Acts.

Although CACs are a significant improvement, many observers consider them not fully sufficient, in particular because they do not address the so-called "aggregation problem." CACs only cover individual bond issues but have no effect on the holders of other issues. For a sovereign that has many bond issuances outstanding, holdout creditors can disrupt the restructuring process by obtaining a controlling position in a single bond issuance. If bondholders of some issues refuse a government's offer, they may have to be paid in full.[18]

E. Special IIA provisions on sovereign debt restructuring

Some recent IIAs contain additional guidelines for the interaction between SDR and the IIA concerned, usually in the form of a special provision or annex on public debt.[19] Although specific language varies across such treaties (see two treaty examples in Box 2), they often prohibit claims relating to a "negotiated debt restructuring", unless an investor contends

Box 2. Examples of SDR related treaty language

Peru-Singapore Free Trade Agreement (2008)

Article 10.1: DEFINITIONS […]

8. negotiated restructuring means the restructuring or rescheduling of a debt instrument that has been effected through (i) a modification or amendment of such debt instrument, as provided for under the terms of such debt instrument, or (ii) a comprehensive debt exchange or other similar process in which the holders of no less than seventy five percent (75%) of the aggregate principal amount of the outstanding debt under such debt instrument have consented to such debt exchange or other process;

ARTICLE 10.18: PUBLIC DEBT

1. The Parties recognize that the purchase of debt issued by a Party entails commercial risk. For greater certainty, no award may be made in favour of a disputing investor for a claim with respect to default or nonpayment of debt issued by a Party unless the disputing investor meets its burden of proving that such default or nonpayment constitutes an uncompensated expropriation for purposes of Article 10.10 (Expropriation and Nationalisation) or a breach of any other obligation under this Chapter.

2. No claim that a restructuring of debt issued by a Party breaches an obligation under this Chapter may be submitted to, or if already submitted continue in, arbitration under this Chapter if the restructuring is a negotiated restructuring at the time of submission, or becomes a negotiated restructuring after such submission, except for a claim that the restructuring violates Article 10.3 (National Treatment) or Article 10.4 (Most-Favoured-Nation Treatment).

3. Subject to paragraph 2, an investor of the other Party may not submit a claim under this Chapter that a restructuring of debt issued by a Party breaches an obligation under this Chapter (other than Article 10.3 (National Treatment) or 10.4 (Most-Favoured-Nation Treatment) unless two hundred and seventy (270) days have elapsed from the date of the events giving rise to the claim.

Central America-Dominican Republic-United States Free Trade Agreement (DR-CAFTA) (2004)

Annex 10-A: Public Debt

The rescheduling of the debts of a Central American Party or the Dominican Republic, or of such Party's institutions owned or controlled through ownership interests by such Party, owed to the United States and the rescheduling of any of such Party's debts owed to creditors in general are not subject to any provision of Section A other than Articles 10.3 [National Treatment] and 10.4 [MFN].

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[18] For example, Eichengreen and Mody (2003) and Hagan (2005).

[19] See for example Peru-Singapore FTA (2008), Article 10.18 "Public Debt", United States-Uruguay BIT (2005), Annex G "Sovereign Debt Restructuring"; Central America-Dominican Republic-United States FTA (DR-CAFTA) (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".

that the terms of the restructuring violate national treatment (NT) or most-favoured-nation treatment (MFN) obligations. Such treaties usually define “negotiated restructuring,” as a restructuring where 75% of the bondholders have consented to a change in payment terms. If an investor does file a claim in the event of a restructuring that is not a “negotiated” one, s/he must honor a “cooling off” period usually lasting 270 days before a claim may be filed.

To summarize, under the Peru-Singapore FTA and other similarly-worded treaties, any country can engage in a “negotiated restructuring” without being liable for losses of foreign investors. However, *non*-negotiated restructuring can be challenged subject to the 270-days cooling-off period. Furthermore, NT and MFN claims may be brought regardless of whether the restructuring is negotiated.

In contrast, the DR-CAFTA FTA specifies very clearly that sovereign debt restructuring is subject *exclusively* to national treatment and MFN obligations. The additional cooling off period is not envisaged, and there is no mentioning of “negotiated restructuring.”

These provisions can be seen as a step in the right direction given that the contracting parties recognize that debt restructuring is a special case, yet questions remain. In particular, as discussed above, economists have repeatedly held that there can be good reasons to discriminate between domestic and foreign bondholders. Also, in relation to the take-it-or-leave-it bond exchanges, it is not clear that such swaps could be deemed as “negotiated.” Finally, vulture funds and other holdouts can acquire more than 25% in a bond issuance in order to block a “negotiated restructuring” and arbitrate instead.

IV. Conclusions and Policy Options

As a matter of policy, it is desirable that countries retain the tools to resolve their debt problems in an effective manner in order to return to normal economic functioning as soon as possible. The ISDS mechanism allowing individual bondholders to arbitrate against the State, especially where a restructuring has been agreed to by the majority, can pose an obstacle to efficient debt restructuring.

Argentina is thus far the only country to be subject to ISDS claims related to the nation’s sovereign debt default and subsequent restructuring. However, 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 has been demonstrated that IIAs and SDRs may overlap and that there remains a window for disappointed bondholders to take the international arbitration option through IIAs.

The most reliable way to avoid this would be to remove sovereign debt from the coverage of the IIAs. As mentioned, some countries have already followed this path. This option is unlikely to have a negative impact on investor confidence and the ability of States to borrow. Another option is to exclude SDR-related issues from the scope of ISDS, leaving them to the IIA’s State-State dispute resolution process. A State may prove to be a more reasonable negotiating partner with a better understanding of underlying political and policy concerns, even though there is no guarantee against a hostile counterpart. It imay also be useful to include the “essential security” exception in the IIA, with a clarification that it covers economic and financial crises. Furthermore, a handful of recent IIAs have included explicit provisions regarding SDR. While also a positive development, such provisions may prove not to be fully adequate for the reasons discussed. Other approaches may be available, and it is in countries’ interest to continue considering these issues and to be proactive in preventing outcomes that could hurt their financial sustainability.

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