Bilateral investment treaties and the resolution of sovereign debt crises

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1. Executive Summary

Recent years have seen a number of initiatives aimed at reducing the social and economic costs of international sovereign debt crises by promoting a more orderly (and hence more timely) resolution of such crises. Some initiatives have actually been implemented by the respective parties involved: contractual Collective Action Clauses (CACs) are inserted into the documentation of new bond issues under US law, and a number of emerging economies and private creditors’ associations have agreed upon the text of non legally binding “Principles for stable capital flows and fair debt restructuring in emerging markets” (hereinafter called “the Principles”). Other initiatives have been shelved, in particular the so-called “statutory approaches” (such as the Sovereign Debt Restructuring Mechanism, SDRM, initially proposed by the First Deputy Managing Director of the IMF, Anne Krueger).

These initiatives, concerning in particular the provision of adequate information and addressing co-ordination problems among creditors, perhaps did not pay sufficient attention to the sometimes kaleidoscopic general legal framework surrounding sovereign debt crises.

Indeed, under international law, several legal norms exist that could impact upon the rights and obligations of the different parties involved in sovereign debt restructuring. Among them are the numerous Bilateral Investment Treaties (BITs). Such BITs in essence aim at attracting foreign direct investment into less developed and emerging economies, by guaranteeing foreign investors the right to individual protection (and, if need be, to appropriate defence and compensation).

In view of the substantive differences, legal as well as economic, between their nature, aim and effects, one would not expect BITs to interfere in any way with crisis resolution initiatives such as CACs. However, this article indicates that there are sound legal arguments permitting private creditors to invoke the protection granted by BITs. That possibility could affect the incentives for different classes of creditors either to participate in a debt restructuring or to hold out. The rights granted to individual creditors by a rather general legal framework (BITs) could hence impact upon the functioning of another, very specific framework, designed to establish a proper balance between the public good of an orderly and timely resolution of a debt crisis, and the preservation of the rights of private creditors as a group (CACs).

Such interaction between two different spheres is unwarranted, in particular as the amounts involved could become significant: in the case of Argentina, the debt remaining unrestructured after the closing of the offer amounts to 19.6 billion USD, or 11.5 p.c. of GDP. The potential direct and indirect costs involved are thus substantial.

A solution to the problem should be sought at the international – and preferably the multilateral – level. Both a multilateral agreement on investment and a multilateral statutory mechanism for debt restructuring could clarify the situation overall, with the latter presenting the advantages of transparency and consistency. In the end, this article therefore adds to the arguments in favour of the international community resuming the work on a sovereign debt restructuring mechanism.
The paper is organised as follows: Section 2 will present the characteristics of BITs and of recent initiatives on a more orderly resolution of sovereign debt crises and their differences, and Section 3 will review classic features of BITs. The likelihood of interference between BITs and CACs will be examined under Section 4, and the nature of such interference will be further explored in Section 5. Section 6 will propose ways to moderate such interference.

2. BITs and recent initiatives on a more orderly resolution of sovereign debt crises

Although both BITs and recent initiatives on a more orderly resolution of sovereign debt crises (see Box 1), in particular CACs, impact on the balance of power between a sovereign State and foreign creditors or investors, they differ substantially on several points:

- **their primary aim**: BITs aim at attracting foreign direct investment, in general, into less developed and emerging markets. In particular, such investment is promoted by granting individual rights to protection to all the nationals of another State who make an investment. By contrast, CACs impact upon the contractual relationship between a State and a debt holder, with regard to a specific portfolio investment. They aim at preventing and, if need be, limiting the overall costs of a debt crisis, by addressing information provision and coordination problems between creditors. Although factual evidence points in the opposite direction, it is widely believed that the insertion of CACs tends to make the bond issue concerned less attractive for foreign investors;

- **their impact on the balance of power**: whereas BITs assign rights and security to individual investors in relation to a sovereign State (the host country), CACs provide a sovereign with the legal tools for increasing the orderliness of a debt workout, while preserving the rights of its creditors as a group (and hence limiting the rights of individual creditors holding out);

- **their origin**: BITs appeared in the early 1960s and were mainly concluded between Western European countries and their former African colonies. Since the 1990s, the number of BITs has proliferated rapidly around the world\(^1\) (see Chart 1). Up to now, more than 2,300 BITs have been ratified, with more than 1,000 for the EU members, and more than 60 for the Belgium-Luxembourg Economic Union\(^2\). On the other hand, the renewed interest in CACs (under New York Law, as they are a standard device under English Law) finds its origin in the aftermath of the Mexican sovereign bond crisis in 1994. Standard clauses have been proposed by the official as well as by the private community, and Mexico has led by example, by introducing CACs in an issue under New York Law in February 2003. The example was followed by many other countries, and (some categories of) CACs are becoming a market standard under New York Law as well;

- **their legal nature**: BITs are treaties, a public law instrument of a general and non-specific nature, while CACs are clauses inserted into one specific contract, and belong to the sphere of private law;

- **the relationship between the home country/sovereign debtor and investors/creditors**: on the one hand, BITs being treaties concluded between States (the home country and the host country), there is *stricto sensu* no contractual relationship between the host country and the foreign investor, who is a third party to BITs. Nevertheless, through the protection granted by BITs, rights are created directly in favour of investors. This is quite normal in international law, and is known as direct applicability. On the other hand, CACs figure in legal instruments concluded directly between a State (the sovereign debtor) and several private parties (its creditors). Therefore, unlike the protection granted by BITs, CACs’ effects are based directly on a contractual relationship between a debtor and its creditors.

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\(^1\) This is similar to what has happened in investment cases between host countries and investors in international arbitration. For instance, from its launch in 1966 until the beginning of 2002, the International Centre for the Settlement of Investment Disputes (ICSID) had registered 95 cases; since then, the caseload of ICSID has grown exponentially by another 73 cases. The ICSID is part of the World Bank Group and was created by the Convention on the Settlement of Investment Disputes between States and Nationals of Other States, Washington, 18 March 1965. At the end of 2004, 142 States had ratified this Convention. ICSID is also competent for disputes involving non-member host countries which have accepted its jurisdiction (through its Additional Facility Rules).

\(^2\) Investments fall within the scope of the Belgium-Luxembourg Economic Union (BLEU) Convention. Therefore, BITs are concluded on behalf of the BLEU.

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**Chart 1**

BITs, 1969-2005

(Cumulative number)

<table>
<thead>
<tr>
<th>Year</th>
<th>Number</th>
</tr>
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<tbody>
<tr>
<td>1969</td>
<td>72</td>
</tr>
<tr>
<td>1970</td>
<td>166</td>
</tr>
<tr>
<td>1971</td>
<td>185</td>
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<td>1972</td>
<td>1,726</td>
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<tr>
<td>1973</td>
<td>2,096</td>
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<tr>
<td>1974</td>
<td>2,300</td>
</tr>
</tbody>
</table>

Source: UNCTAD
Box 1 – Recent initiatives on a more orderly resolution of sovereign debt crises

In countries with excessive debt levels, a timely and orderly restructuring of sovereign debt may be appropriate to avoid problems of debt overhang and debt panics. Debt overhang may inefficiently reduce investment and growth in the debtor country, so that debt restructuring might benefit not only debtors but also creditors overall. Debt panics due to self-fulfilling runs by creditors may entail systemic risks involving capital flight, exchange rate problems and banking crises affecting the creditor countries also.

Timely debt workouts, however, may be hampered by coordination problems due to diverging incentives for the creditors. Individually, creditors have incentives to race to the courthouse to call in their claims against overextended countries or to hold out in debt renegotiation, thereby impeding or delaying the conclusion of debt restructuring. Renegotiation encourages free riding as a debt write-down by other creditors will increase the capacity of the debtor to repay the remaining creditors. A collective action problem arises as the destructive race to liquidate assets injures the economic performance of the debtors so much that the creditors suffer collectively(1).

In addition to promoting the provision of timely and accurate information, recent initiatives on a more orderly resolution of sovereign debt crises, in particular, address such collective action problems.

CACs are clauses to be incorporated in sovereign debt contracts and aiming mainly at making the process for restructuring sovereign debt more orderly by:
– fostering early dialogue, coordination and communication among creditors and a sovereign debtor;
– ensuring that there are effective means for creditors and debtors to re-contract, without a minority of debt-holders being able to obstruct the process;
– ensuring that disruptive legal action by individual creditors does not hamper a workout that is under way, while protecting the interests of the creditor group.

CACs thus tend to shift away from the individual investor/creditor, aiming at protecting the public interest while preserving the interests of investors/creditors as a group.

The “Principles for stable capital flows and fair debt restructuring in emerging markets” are the result of a joint effort, supported by the official community, of emerging markets issuers (primarily Brazil, Korea, Mexico and Turkey) and private sector representatives (e.g. the Institute of International Finance and the International Primary Markets Association). Their aim is to provide a market-based, voluntary and flexible framework for cooperation between debtors and creditors in order to contain crises at an early stage and to facilitate debt restructurings. The Principles are based on four pillars:
– transparency and timely flow of information;
– close debtor-creditor dialogue and cooperation to avoid restructuring;
– good faith actions during debt restructurings by debtors and creditors;
– fair treatment of all creditors.

In view of their voluntary nature, the Principles are not legally binding, and none of their provisions is deemed to constitute a waiver of legal rights.

The Principles were subscribed to by the public and private parties mentioned above in November 2004; they were welcomed by the G20 (20-21 November 2004).

(1) Debt forgiveness might benefit not only debtors, but also creditors if the write-down of nominal claims was more than offset by an increased likelihood that the country might repay its remaining debt. For further arguments, see Rogoff K. and J. Zettelmeyer (2002), “Bankruptcy Procedures for Sovereigns: A History of Ideas 1976-2001”, IMF Staff Papers, 49 (3), 470-507.
From their substantially different legal nature and features, as well as from their diverging economic rationale, one would tend to conclude that there should be no major interference between BITs and CACs. The question arises, however, whether the protection granted by BITs to some individual creditors may not affect their incentives to litigate or to hold out in a debt renegotiation process, and thus interfere with the implementation of the framework provided by CACs. Hence, the protection granted by BITs and the particular clauses they contain in this respect should be further analysed.

3. An introduction to BITs

BITs around the world share a lot of common features: they define the kind of investments that they protect (3.1), they contain some classic clauses (3.2) and they address the issue of discrimination between foreign investors (3.3).

3.1 Investments protected by BITs

The traditional aim of BITs is to promote and to protect investments reciprocally (although it is clear that the economically less strong partner hopes to benefit most). Investments are traditionally defined by BITs as any kind of assets and capital, monetary claims and titles to performance, copyrights and industrial property rights, and concessions and similar rights. For instance, the definition included in the BLEU model text is:

“The term ‘investments’ shall mean any kind of assets and any direct or indirect contribution in cash, in kind or in services, invested or reinvested in any sector of economic activity.

The following shall more particularly, though not exclusively, be considered as investments for the purpose of this Agreement:

a) movable and immovable property as well as any other rights in rem, such as mortgages, liens, pledges, usufruct and similar rights;
b) shares, corporate rights and any other kind of shareholdings, including minority or indirect ones, in companies constituted in the territory of one Contracting Party;
c) bonds, claims to money and to any performance having an economic value;
d) copyrights, industrial property rights, technical processes, trade names and goodwill;
e) concessions granted under public law or under contract, including concessions to explore, develop, extract or exploit natural resources.

Changes in the legal form in which assets and capital have been invested or reinvested shall not affect their designation as ‘investments’ for the purpose of this Agreement.”

The investors concerned are defined as the nationals (citizens and companies) of each Contracting Party.

3.2 Classic clauses of BITs

The goal of BITs is not the opening of markets as such (as opposed to the draft Multilateral Agreement on Investment – MAI – of the OECD(1)) but to promote investments in sectors which the host country authorities have already opened up unilaterally. This promotion implies protection, through a limitation of the powers of the host country in its capacity as a sovereign State, in order to provide legal security to foreign investors or investments, in an environment in which such security cannot be taken for granted.

Although the interpretation of some clauses may differ between the major geographical regions of the world, the content of BITs is rather similar, irrespective of domestic legal systems. BITs generally contain clauses on:

– promotion and admittance of investments;
– protection stricto sensu of investments (fair and equitable treatment, full protection and security, prohibition of unjustified or discriminatory measures);
– national treatment of investors;
– most favoured nation (MFN – see below);
– expropriation (see point 5.1);
– free transfer of capital (see point 5.3);
– subrogation of investors by the home country or by its credit insurance institution;
– settlement of investor-host State disputes (see point 5.2);
– settlement of State-State disputes;
– umbrella clause: BITs usually offer the investor the right to choose the legal regime which is the most favourable to the investor (contractual agreement with the host country, BIT, multilateral agreement, laws of the host country… – existing or to be subscribed to by the host country).

(1) Between 1995 and 1998, the MAI was negotiated within the OECD (Argentina, Brazil, Chile, Hong-Kong, Estonia, Latvia, Lithuania, and the Slovak Republic being invited as observers). Under the terms of reference, the MAI was to be a “Free standing international treaty, open to all OECD Members and the European Communities, and to accession by non-OECD Member Countries”. Its proposed objective was to “provide a broad multilateral framework for international investment with high standards for the liberalisation of investment regimes and investment protection and with effective dispute settlement procedures”. Negotiations ceased in December 1998, due to strong international criticisms (too liberal text, issues of environment and labour insufficiently addressed, negotiation of the text in a club of developed countries…).
3.3 BITs and discrimination

Despite the broad similarity in content, BITs could be a source of discrimination between investors from different countries, but as a rule such potential discrimination is addressed by the MFN clause. According to this clause, investors and their investments will be treated no less favourably than the investors from other countries.

The only traditional exception to the MFN clause concerns privileges granted to investors from certain countries by virtue of participation in or association with a free trade area, customs union, common market or any other form of regional economic organisation.

Discrimination will, however, remain possible between investors from countries which have concluded BITs with the country hosting the investments and those from countries which have not concluded BITs, or those which have concluded BITs with a more limited scope. This potential discrimination can affect bondholders’ class actions. Indeed, if BITs provide a particular class of bondholders with additional enforcement mechanisms / legal protection grounds in case of sovereign default, that may provide them with more incentives for legal action, resulting eventually in uncoordinated litigation.

4. The likelihood of interferences between BITs and CACs

There is no real consensus on classifying bonds as investments falling within the scope of BITs, but there is a growing trend towards doing so (4.1). Economic considerations may also shed some light on the issue (4.2). Finally, the possibility that one legal framework could prevail over the other will be examined (4.3).

4.1 BITs and bonds: Do bonds fall within the scope of BITs?

Neither legal practice nor legal doctrine offers an unambiguous answer to the question whether sovereign bonds qualify as investments under the terms of BITs. The issue can be addressed at two levels:

– as mentioned under point 3.1, the definition by BITs of the notion of investment is rather broad and exemplified by a non exclusive list of categories. Two of those categories (monetary claims and rights in companies(1)), open the door for the inclusion of bonds. Moreover, several BITs (European-style BITs – including the BLEU –, US BITs…) explicitly mention bonds in their definition of the term “investment”. This was also the case with the draft text of the MAI (see footnote 1 p. 4). Some BITs, or BITs-like agreements, explicitly exclude port-folio investments from the definition of “investment” (ASEAN Framework Agreement on Investment…). This could be seen as an a contrario sign that portfolio investments are covered by the definition of “investment” if not explicitly excluded;
– cases concerning debt instruments are rather rare in international arbitration. However, some recent rulings confirm the trend mentioned above(2). Current cases involving countries such as Argentina will also probably help to shed some light on this issue.

If bonds as such are protected as investments by BITs, does this protection extend to bonds issued by a sovereign? Some arguments point to a positive answer: first, the ordinary meaning of “bond” already includes governments as possible issuers of bonds(3). Second, BITs explicitly defining bonds as investments do not make any distinction between the numerous categories of bonds. Moreover, and a contrario, some BITs protecting bonds explicitly exclude from their scope bonds issued by a State (e.g. Spain – Mexico BIT, 1995). Third, during the MAI negotiations, a broad majority was in favour of including bonds issued by a public authority in the scope of the MAI. However, the discussion was inconclusive about potential interference by the MAI in public debt restructuring arrangements, and about the possibility of inserting a limited carve-out clause in the MAI to cater for that.

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(1) E.g. “shares or bonds, equity as well as debt.”
(3) According to the Shorter Oxford English Dictionary, a bond is “a deed by which one person binds himself or herself to pay another, a (government) documentary promise to repay borrowed money, usu. with interest, a (debenture) an insurance policy, a financial guarantee against the collapse of a company, esp. a tour operator etc.” (our underlining). In financial law dictionaries, “bond” is “a long term, interest bearing instrument issued by a corporation or government to provide for a particular financial need” (our underlining).
4.2 Economic considerations

An analysis of the economics underlying the conclusion of BITs may also provide some insights into the issue at stake.

BITs are concluded with the aim of augmenting more legal certainty for investments abroad, and hence reducing transaction costs and increasing international capital flows. The protection offered by BITs is particularly needed in order to increase the flow of international direct investments, given the high risks involved in risk capital financing.

One would therefore be tempted to exclude bonds, and in particular sovereign bonds, from the scope of BITs, as these instruments have very little to do with the aim of BITs, i.e. promoting risk capital financing by non residents.

It could be argued that sovereign bonds contribute to this aim indirectly. Indeed, to the extent that the sovereign finds its financing abroad, a larger amount of domestic savings will be available for investment purposes. Such reasoning, however, is a long shot, and disregards the second important aspect of BITs, next to attracting foreign financing, i.e. transfer of expertise between the home and the host country, by establishing long lasting and direct links between the economies involved.

4.3 Does one legal framework prevail over the other?

From the considerations in the two paragraphs above, it follows that the economic rationale for including bonds under the protection framework offered by BITs is weak, but that sound legal arguments could be invoked for doing so nevertheless.

Where BITs exist alongside CACs, for instance, the question arises whether one legal framework should normally prevail over the other. One might think that the umbrella clause (see above, point 3.2) would enable CACs to prevail over the protection granted by BITs. However, this interpretation of the umbrella clause would directly contradict its goal, which is to ensure the most favourable treatment for the investor, and should therefore be rejected. CACs could also be considered as an exception to BITs according to the general principle of international law lex specialis derogat legi generali (the more specific text prevails over the general). However, there is no real guarantee that this principle would apply in this case, as there is not really any direct link between BITs and CACs, and it is therefore not self-evident that CACs should be classed as a specific implementation of the more general principles contained in BITs. Moreover, the application of the lex specialis principle was recently ruled out in some international arbitration cases on the specific jurisdiction issue, allowing investors to refer a contract dispute to an arbitral tribunal on the basis of BITs despite the existence of different dispute settlement clauses in the contract(1).

5. Specific BITs clauses

In a scenario of CACs existing alongside BITs, several BITs clauses can interfere with the initiatives on a more orderly resolution of sovereign debt crises. In order to avoid becoming too technical, only three – the most obvious – cases are illustrated hereunder. These relate to the expropriation clause (5.1), the settlement of investor-State disputes clause (5.2), and the clause on the free transfer of capital (5.3).

5.1 The expropriation clause

Most BITs contain a clause stating that investments must not be expropriated or nationalised, except for a public purpose, in a non-discriminatory manner, in accordance with due process of law and against payment of prompt, adequate and effective compensation. This rule is confirmed by numerous cases and is considered part of customary international law.

“Expropriation”, or “deprivation of ownership”, or “taking”, are used by BITs but seldom defined by them. However, the ordinary meaning (to legally take away something for public use or benefit) is self-evident. “Nationalisation” belongs to the same category but implies an operation on a larger scale.

Measures taken in a different legal form but having the same effect are increasingly treated in the same way as expropriation and nationalisation stricto sensu. Those measures are often qualified as indirect (or creeping, or de facto) expropriation.

There is no definition of indirect expropriation in BITs (except in the new US model BIT\(^{(1)}\)). However, jurisprudence and the literature lead to a definition of indirect expropriation as interference by a state in the use of an investment or with the enjoyment of the benefits, even where the investment is not seized and the legal title to the investment is not affected.

Measures taken in the context of a sovereign debt crisis, for instance a bond restructuring, can seriously affect the economic value of the assets concerned. Could such a restructuring be considered as an indirect expropriation, falling therefore within the scope of BITs, and requiring compensation? The line between indirect expropriation and the sovereignty of a State is very thin. For instance, measures taken in the general interest come under the State’s right to regulate, and are not considered as indirect expropriation but as regulations which do not give rise to any compensation.

This specific issue is not addressed by legal texts, but an analysis of jurisprudence shows the existence of several criteria determining whether an indirect expropriation has occurred: the degree of interference, its duration, its sole effect on the investor, its purpose and its context…. Among those criteria, some could be helpful in deciding whether or not a restructuring qualifies as an indirect expropriation: (i) the degree of interference, understood as the severity of the economic impact caused by a government action, (ii) the purpose or the context, for instance an economic crisis and its severity, (iii) the interference with reasonable investment-backed expectations, when the restructuring is not fair for creditors, or (iv) the discriminatory character, if discrimination is applied between creditors (between domestic and foreign creditors, between institutional and small investors, or between other classes of creditors).

Nevertheless, there is no jurisprudence on this very precise issue. Future rulings by the ICSID on several cases involving Argentina will certainly be of some relevance on this question. Indeed, among creditors of Argentina, the Global Committee of Argentina Bondholders is currently envisaging using the expropriation clause to challenge the Argentine restructuring proposal.

In the case of recent initiatives on a more orderly resolution of sovereign debt crises, the expropriation clause would cause serious interference: whatever the restructuring terms sanctioned by these initiatives, hold out creditors would still be able to request full compensation for the indirect expropriation imposed on them.

As creditors have more incentives to hold out when they are protected under the umbrella of BITs, the collective action problem becomes worse, hampering a timely and orderly debt workout. The problem may even be exacerbated if the distressed bonds are actively traded in secondary markets and acquired by bondholders from countries who expect their investments to be protected by BITs.

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**Box 2 – The sovereign strikes back**

This article, as well as other publications on the subject, including some by bondholders, follows the pattern of a private bondholder invoking a BIT against a sovereign. However, it seems that, at least in theory, the sovereign can also make use of some clauses contained in BITs, against (hold out) bondholders. An avenue of the kind is provided by a traditional clause on nationalisation and expropriation.

Most BITs state the general principle that investments by investors of the other contracting party must not be nationalised or expropriated, neither directly, nor indirectly. However, it is equally traditional to formulate exceptions to this rule. The conditions put forward for such exceptions include provision for the payment of a prompt and adequate compensation. The amount of such compensation should be equal to the real value of the investment, i.e. the market value on the day preceding the day on which the imminent nationalisation or expropriation is decided or becomes common knowledge.

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A sovereign could try to invoke this clause against bondholders holding out in a debt restructuring, in order to avoid being obliged to reimburse 100 p.c. of the bond’s nominal amount plus interest. For such a defence to be successful (i) the restructuring offer must qualify as a nationalisation or expropriation and (ii) the haircut proposed must not exceed the discount at which the bond issue concerned was quoted \textit{in tempore non suspecto}.

We refer to the main text for considerations with regard to the first condition. The issue of market quotation “under normal circumstances”, raised by the second condition, constitutes a factual question. Below is an illustration: the graph plots the quotation of one particular Argentine bond issue contained in the restructuring offer (the same pattern applies broadly to other comparable bond issues), while indicating events which could be considered relevant to the question whether an upcoming expropriation was either publicly announced or had become public knowledge.

\begin{center}
\textbf{CHART 1} \textbf{MARKET QUOTATION OF A BOND ISSUED BY THE ARGENTINE REPUBLIC (AR. REPUBLIC, 9 P.C., DUE 09, EUR) AND RELEVANT EVENTS}
\end{center}

1. 2000-03-10 IMF Board approves a 7.2 billion USD stand-by arrangement with Argentina. The Argentine authorities indicate that they intend to treat the credit as precautionary.
2. 2001-01-12 IMF Board approves augmentation of Argentina’s stand-by arrangement to 13.7 billion USD. At the same time, additional financing is arranged from official and private sources.
3. 2001-03-26 International rating agencies lower Argentina’s long-term sovereign rating.
4. 2001-04-14 Minister of Economy Cavallo announces a modification of the convertibility law, with the replacement of the dollar by an equally weighted basket of the dollar and the euro.
5. 2001-05-08 S&P lowers Argentina’s long-term sovereign rating further from B+ to B.
6. 2001-06-04 Authorities announce the completion of the mega-swap, involving the voluntary exchange of some 29 billion USD in mainly near-dated securities for longer-dated, higher-yielding bonds.
7. 2001-06-15 Mr. Cavallo announces a package of tax and trade measures to stave off a potential debt default, including a trade compensation mechanism for exporters and importers. Concern that this is a first step towards full-scale devaluation sends the price of Argentina’s bonds tumbling as a devaluation would force the government to default on its huge debt.
8. 2001-08-10 Press quotes market sources to report that an IMF package will only delay the default.
9. 2001-08-21 IMF announces planned augmentation of Argentina’s stand-by arrangement by 8 billion USD.
10. 2001-09-07 IMF Board approves augmentation of Argentina’s stand-by arrangement (to 22 billion USD), with up to 3 billion USD set aside to be used in support of a possible voluntary and market-based operation to increase the viability of Argentina’s debt profile.
The haircut included in the Argentine offer is generally estimated at between 65 and 70 p.c. Depending on the precise date judged as being the moment on which the expropriation was decided or became public knowledge, the offer could therefore be judged as being above or below market conditions. Interestingly, market quotation has been consistently below 100 p.c., implying that under the terms of the expropriation clause of a BIT, the sovereign would never be obliged to reimburse the full nominal amount.

Be that as it may, if and when BITs are judged to apply in cases of debt restructuring, the ultimate outcome of the proceedings could be beneficial for either the sovereign or the bondholder. BITs could therefore interfere in a very complex manner with recent initiatives to promote a more orderly debt crisis resolution.

5.2 The settlement of investor-State disputes clause

The coordination problems due to divergent incentives for creditors in sovereign debt restructurings are compounded by the variety of procedures available for the settlement of disputes. Different options given to all creditors, or to different classes of creditors, may become a source of uncoordinated litigation, rendering the solution of collective action problems even more difficult.

Under BITs, a dispute between an investor and a host country can be submitted, usually at the option of the former, to the national jurisdictions of the country concerned or to international arbitration. For international arbitration, BITs propose one or several fora. For instance, in the BLEU model text, these fora are the ICSID, ad hoc tribunals (set up according to the arbitration rules laid down by the United Nations Commission on International Trade Law), the International Court of Arbitration in Paris, and the Arbitration Institute in Stockholm.

As a rule, the possibility of submitting the dispute to a court of the investor’s choice is conditioned only by time constraints, as most BITs reserve some time for the amicable settlement of the dispute (consultation, negotiation...), ranging usually between three and twelve months. Once this period has elapsed, the dispute can be referred to a court: the investor does not need to obtain the consent of the host country before going to international arbitration (such consents are usually irrevocably expressed in BITs). Moreover, several BITs even contain an explicit clause providing that local remedies do not have to be exhausted.

In contrast, CACs limit an investor’s right of litigation (before a domestic court, usually of the same nationality as the law applicable to the issue). For instance, the G10 set of CACs offers the possibility of a stay of legal action, providing a sovereign with a breathing space from disruptive litigation during the period in which it is organising its affairs after a default, and in anticipation of a restructuring. Another clause concentrates the power to initiate litigation within a bondholder representative.
5.3 The free transfer of capital clause

This classic clause provides that international transfers relating to an investment (exemplified by a non exhaustive list) can be made freely and without undue delay. Some BITs do not limit such free transfer at all, some contain restrictions which can vary. A reference to domestic laws and regulations (including exchange controls), or the possibility of suspending the free transfer of capital temporarily in the case of balance-of-payment problems are obvious examples.

In the heat of a debt crisis, it could be assessed appropriate to impose temporary exchange controls in order to prevent the crisis from being exacerbated by “speculative” capital flows.

If a BIT contracted by the country concerned does not deal with the issue explicitly, could the imposition of exchange controls possibly be deemed contrary to the free transfer of capital ensured by the BIT? The issue is not settled by jurisprudence, and the doctrine is divided. Some authors hold the view that temporary exchange controls would indeed constitute a breach of the BIT concerned, while others defend the position that the controls would be allowed, either on the basis of the clausula rebus sic stantibus (all things remaining equal) principle, or on the basis of the general principle of necessity. Here again, future jurisprudence on Argentina will probably shed some light.

In the absence of a global institution having jurisdiction over the temporary imposition of exchange controls, such a measure is a complex and delicate undertaking, from a legal and administrative point of view. If surrounded by too high a level of uncertainty, e.g. due to possible inconsistency with the rights and obligations stemming from BITs, evasive mechanisms could be set up quickly and successfully, and the impact on the markets could diminish or even become negative, as the main effect of the measure could be to add to the anxiety in the markets.

Box 3 – Belgian law, Euroclear and litigation relating to sovereign debt crises

Other factors, such as national legislation, can also interfere with sovereign debt crisis resolution.

Euroclear – an International Central Securities Depository established in Belgium – was recently involved in two cases under Belgian law between a sovereign debtor and one of its creditors not participating in a debt rescheduling: the Elliott case and the LNC case.

In 2000, LP Elliott Associates obtained an order from the Brussels Appeals Court preventing Euroclear from accepting payment or paying out cash from Peru to discharge the interest due on Peru’s Brady bonds. This order was granted without the defendants, Euroclear and Peru, being given the opportunity to present their counter-arguments. It was based on a broad interpretation of the pari passu provision. According to this interpretation, Peru could not make interest payments on its restructured sovereign bonds (Brady bonds) without at the same time making proportionate payments to holdout creditors (Elliott). Peru decided to settle amicably with Elliott in order to avoid being forced to default on its Brady bonds payments.

In 2003, on the basis of the same interpretation of the pari passu provision, LNC, a US debt collection company, obtained an order from the Brussels Commercial Court preventing Euroclear from accepting payment or paying out cash in respect of Nicaragua bonds. This order was also granted without the defendants, Euroclear and Nicaragua, being given the opportunity to present their counter-arguments.

The issue raised by those cases was addressed in two ways: first, by the (at least) partial reversal of the “Elliott jurisprudence”, and second, by an amendment to the Belgian legislation.

Reversal of the “Elliott jurisprudence”: in 2004, following the appeal lodged by both Nicaragua and Euroclear, the Brussels Court of Appeal dismissed LNC’s claim, mainly for the reason that a third party (Euroclear) to a contract (between LNC and Nicaragua) cannot be considered as liable for the execution of that contract (which was the
result of the appealed order). The Court did not even have to look into the interpretation of the pari passu provision. However, LNC lodged a new appeal (pourvoi en cassation), before the Belgian Supreme Court (Cour de Cassation), on the grounds that the conclusion of the Brussels Court of Appeal was based on an erroneous interpretation of Belgian law. The Belgian Supreme Court is not expected to rule on LNC’s appeal before the end of 2005.

**Amendment of the Belgian legislation**: A Belgian law of 28 April 1999 prohibits the attachment of any cash settlement account held with the operator of a payment system or of a securities settlement system designated by the said law, or with the settlement agent of one of those systems. This law aims to ensure that the smooth functioning of a payment or securities settlement system is not paralysed or impaired by an attachment or sequestration, or by a court order blocking an account. But Elliott and LNC, with their respective claims, circumvented the objective of protection sought by this law, by blocking a payment to be credited to a settlement account in a protected system, thus at a stage prior to it being registered in the account. Therefore, in order to safeguard the full effect to the 1999 law, the Belgian Government proposed to amend it, by providing that the rules also apply to transfers of sums to be credited to a cash settlement account through an intermediary acting as cash correspondent (i.e. a Belgian or foreign credit institution). This amendment was adopted by the law of 6 December 2004 amending insolvency rules concerning credit institutions and insurance undertakings. The law was published on 28 December 2004, and entered into force on 7 January 2005. The amended text provides: “Any cash settlement account maintained with the operator of a system or with a cash settlement agent, as well as any cash transfer, through a Belgian or foreign credit institution, to be credited to such cash settlement account, cannot be attached, put under sequestration or otherwise blocked by any means by a participant (other than the operator or the settlement agent), a counterpart or a third party.”

6. Possible solutions

As already mentioned, interference by BITs is due to the progressive extension of their scope and to their increasing number, but also to the fact that recent initiatives on a more orderly resolution of sovereign debt crises do not pay sufficiently due attention to the legal framework surrounding sovereign debt crises.

From the preceding chapter it follows, however, that it is uncertain whether the potential interference described will occur in real life. Therefore, one could imagine leaving things as they are and waiting for the development of a jurisprudence. Such a solution could never be entirely satisfactory, as due to the case-by-case nature of jurisprudence and the lack of unity in international arbitration, complete legal certainty will never be attained. Another factor to take into account is that, while the overall impact of hold out creditors has usually been considered relatively limited until now, the current Argentine restructuring, with the hold out creditors accounting for some 14 p.c. of the country’s outstanding debt (or 11.5 p.c. of the country’s GDP), could greatly increase the risks of a wait-and-see solution.

Since the type of interference under review is of a formal legal nature, it can only be addressed by legally binding rules. It would therefore be useless to try to devise a solution through “the Principles” (see Box 1) or other kinds of gentlemen’s agreements.

As BITs may amplify collective action problems in two major respects, a solution favouring timely and orderly debt workouts should also address both aspects. First, as the additional enforcement mechanisms provided by BITs may give investors more scope and incentives to hold out and to litigate, the protection given should be curtailed in the case of a sovereign debt crisis. Second, the bilateral approach taken by BITs introduces preferential treatment features, making the necessary coordination among bondholders more difficult. To avoid such problems in a sufficiently general way, a multilateral approach is in order.

From a legal point of view, two solutions could be designed in the optimal form of multilateral instruments: a multilateral instrument dealing with international investment (6.1) and a multilateral instrument dealing with more orderly resolution of sovereign debt crises (6.2). These two solutions are not mutually exclusive; in order to avoid any conflict such as those described under point 4.3, and therefore to ensure greater legal certainty, they could be complementary.
6.1 Multilateral instrument dealing with international investment

The issue could be addressed from the “Investment Treaty” angle, with the insertion in every BIT of a carve-out clause concerning public debt and/or sovereign debt crisis. However, this solution is not realistic, bearing in mind the growing and already daunting number of BITs. Moreover, this insertion would only work for the future, which would have an a contrario effect on the classification of bonds as investments under existing BITs. A multilateral instrument would not suffer from this drawback.

The text of a multilateral carve-out clause would have to be very precise, in order not to exclude public debt entirely from the protection of an investment instrument. Indeed, some rules of investment law have a beneficial function, such as the MFN clause for instance. Its text could be similar to one of those discussed during work on the MAI in the OECD:

“A breach by a government of a public debt obligation in the context of a general debt default or general debt restructuring, including an imminent debt default or restructuring, is not a breach of the MAI. Any general rescheduling or reorganisation of such public debt obligations is not subject to the MAI, and a sanctioning by a government of a general workout of debt contracted by private parties is not a breach of the MAI.

A general debt restructuring includes, but is not limited to, a debt restructuring in the Paris Club or the London Club. A breach of a public debt payment obligation by a government is a failure of a government, entity or enterprise controlled by a government, to make a timely payment of its obligation under:

a) a public debt instrument; or
b) a governmental guarantee.

A public debt instrument includes a bond or note issued by a government, or a loan made to a government.”

A carve-out clause focused on disputes on sovereign debt default and sovereign debt restructuring could also be designed with regard to the settlement of investor-State disputes clause.

However, the success of such clauses presupposes the successful launching of work on such a multilateral instrument (in the OECD, the WTO, or some other international organisation), and could only be ensured if the instrument were adopted by several countries, including those most concerned by sovereign debt crises, i.e. emerging market countries. If those countries did not adopt this multilateral instrument, their sovereign bonds would still fall within the scope of BITs.

6.2 Multilateral instrument dealing with more orderly resolution of sovereign debt crises

Another possibility would be to address the problem from the “Sovereign Crises Resolution” angle. Indeed, a multilateral instrument dealing with a more orderly resolution of sovereign debt crises, enshrined in an international treaty, could contain some rules relating to other treaties, such as BITs.

One clause would provide a specific institution with exclusive competence over issues arising from a sovereign debt default and a sovereign debt restructuring.

A complementary clause would exclude the application of investment instruments (BITs or MAI) to sovereign debt default and sovereign debt restructuring.

However, as in the case of the solution described under point 6.1, and for the same reason, this kind of solution would only work if the treaty enshrining this multilateral instrument were globally ratified.

This option would benefit from a higher degree of transparency when compared to the option presented under point 6.1, as all the features linked to a sovereign debt workout would be dealt with in the same instrument. It would also be more consistent, as it would not only ensure that BITs will no longer have the potential to interfere with the resolution of debt crisis, but would also establish in the same text the procedure to be followed in such cases.

To achieve this, works on such an instrument should be relaunched in international fora. Bearing in mind its experience on the SDRM and its almost universal membership, the IMF seems to be the appropriate place for doing so. In any case, the road ahead will be a long and difficult one.
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