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Rogue Debtors and Unanticipated Risk

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International investment always carries a certain amount of risk. However, the current economic climate is particularly challenging as a result of various states' aggressive and often non-traditional investment policies[1] as well as an increase in political instability in several regions.[2]

Although investors are routinely required to calculate financial

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1 *See* Larry Catá Backer, *Sovereign Investing in Times of Crisis: Global Regulation of Sovereign Wealth Funds, State-Owned Enterprises, and the Chinese Experience,* 19 TRANSNAT'L L. & CONTEMP. PROBS. 3, 11-13 (2010) (describing how sovereign wealth funds have become more aggressive in their "scope and form" over the last decade); Larry Catá Backer, *Sovereign Wealth Funds as Regulatory Chameleons: The Norwegian Sovereign Wealth Funds and Public Global Governance Through Private Global Investment,* 41 GEO. J. INT'L L. 425, 425-30 (2010) (arguing that states have become increasingly dependent on direct foreign investment); Clement N. Fondufe & Sara Mansuri, *Doing Deals in Africa - Reflections on What is Different and What is Not,* 14 BUS. L. INT'L 163, 173 (2013) (noting that in Africa "there is an uptick in the volume of capital markets work in the form of private and public offerings to raise funds for different investments"); David B. Wilkins & Mihaela Papa, *The Rise of the Corporate Legal Elite in the BRICS: Implications for Good Governance,* 54 B.C. L. REV. 1149, 1150 (2013) (discussing investment patterns in Brazil, Russia, India, China, and South Africa).

2 *See* Sophie Brown, *Report: Political Instability on the Rise,* CNN.com (Dec. 12, 2013), http://edition.cnn.com/2013/12/11/business/maplecroft-political-risk/; *see also* MAPLECROFT, POLITICAL RISK ANALYSIS (2013), *available at* http://maplecroft.com/about/news/pra_2013.html (noting "extreme risk" of resource nationalism and expropriation in twenty-one nations); MULTILATERAL INVESTMENT GUARANTEE AGENCY (MIGA), WORLD BANK GRP., 2012 WORLD INVESTMENT AND POLITICAL RISK 29 (2012) [hereinafter MIGA], *available at* http://www.miga.org/documents/WIPR12.pdf (discussing how and when countries become crisis-prone).

risks,[3] "political risk events are not easily predictable."[4] In particular, it is extremely difficult to anticipate whether a particular nation will become a so-called "rogue debtor," meaning a state that "take[s] purposeful advantage of [its] de facto immunity to walk away from legal and financial obligations."[5]

The concept of sovereign default is not new.[6] However, the possibility of rogue debtors presents problems for both individual investors[7] and "the integrity and efficiency of international capital markets" as a whole.[8] One primary concern involves questions about how creditors can recoup or protect against losses in cases of sovereign default.[9]

Traditionally, states, markets and investors have attempted to

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[3] *See, e.g.*, Karen Halverson Cross, *Sovereign Arbitration*, *in* SOVEREIGN DEBT MANAGEMENT ¶¶ 12.31, 12.43 (Rosa Lastra & Lee Buchheit eds., forthcoming 2014).

[4] MIGA, *supra* note 2, at 42.

[5] Arturo C. Porzecanski, *From Rogue Creditors to Rogue Debtors: Implications of Argentina's Default*, 6 CHI. J. INT'L L. 311, 316 (2005). *See also* MIGA, *supra* note 2, at 33 ("Although defaults and expropriations rarely coincide in the same year, they are historically related in the sense that the same types of countries seem to engage in both over the long term.").

[6] *See* Faisal Z. Ahmed et al., *Lawsuits and Empire: On the Enforcement of Sovereign Debt in Latin America*, 73 L. & CONTEMP. PROBS. 39, 39 (2010) (discussing the history of sovereign default); Rodrigo Olivares-Caminal, *The* Pari Passu *Interpretation in the* Elliott *Case: Brilliant Strategy But An Awful (Mid-Long Term) Outcome?*, 40 HOFSTRA L. REV. 39, 56-58 (2011) (detailing the history of sovereign default in Latin America starting with Peru in 1985); Porzecanski, *supra* note 5, at 316, 325 (discussing Argentina's "unparalleled" history of sovereign default).

[7] *See* Stephen J. Choi et al., *The Evolution of Contractual Terms in Sovereign Bonds*, 4 J. LEGAL ANALYSIS 131, 131-32 (2012) ("From the perspective of outside investors, distinguishing a good from bad state can be difficult."); Anna Gelpern, *A Skeptic's Case for Sovereign Bankruptcy*, 50 HOUS. L. REV. 1095, 1118 (2013) (noting that certain members of the creditor community framed some of Greece's legislative efforts to address sovereign debt restructuring as "lawless" in nature); Olivares-Caminal, *supra* note 6, at 63 (discussing the risk associated with including a *pari passu* clause in a bond).

[8] Porzecanski, *supra* note 5, at 316. To some extent, advanced economies may be at a higher risk for sovereign default than rising nations, although sovereign default is often analyzed in conjunction with the risk of expropriation, which is traditionally associated with rising nations. *See* MIGA, *supra* note 2, at 39.

[9] *See* MIGA, *supra* note 2, at 39 ("As the emerging economies have relied more on FDI as a substantial source of foreign currency in recent years, expropriation risk seems to be relatively higher."); Cross, *supra* note 3, ¶¶ 12.29-12.51, tbl. 12.1 (discussing sovereign default in the context of *Abaclat v. Argentine Republic*); Fondufe & Mansuri, *supra* note 1, at 165 (arguing that "we are witnessing a rush by foreign investors to bid for opportunities in the most lucrative industries" in Africa); Olivares-Caminal, *supra* note 6, at 60-63 (discussing sovereign default in Argentina).

manage risk through regulation, insurance and private contract.[10] However, conventional forms of regulation are problematic in the international context because of the absence of single political actor that can address wrongful behavior and associated legal injuries in a comprehensive manner.[11] Contract and insurance-based remedies can be difficult or expensive to obtain because sovereign default tends to be associated with "idiosyncratic economic shocks" that are difficult to predict.[12] All of these approaches also tend to be limited to cases where the possibility of sovereign default has been anticipated in advance.[13]

However, there are other ways to address sovereign default.[14] One mechanism, known as "regulatory litigation," may be particularly useful, since it focuses on unanticipated risk.[15] According to theorists, regulatory litigation allows both public and private actors to fill certain gaps in the relevant regulatory regime by using a "legal remedy or the settlement equivalent in order to influence future, risk-producing behaviors."[16] Although this device has been successful in cases involving corporate

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[10] *See* MIGA, *supra* note 2, at 37, 42 (discussing risk aversion in emerging economies); Iman Anabtawi & Stephen L. Schwarcz, *Regulating* Ex Post: *How Law Can Address the Inevitability of Financial Failure*, 92 TEX. L. REV. 75, 91 (2013) (discussing mitigation of risk in the financial context); Choi et al., *supra* note 7, at 132 (discussing risk management in sovereign debt investments); Olivares-Caminal, *supra* note 6, at 46-49, 62-63 (discussing use of *pari passu* clauses).

[11] *See* Cross, *supra* note 3, ¶¶ 12.52-12.56 (detailing the problems with establishing a single tribunal for investment claims); Richard A. Nagareda, *Aggregate Litigation Across the Atlantic and the Future of American Exceptionalism*, 62 VAND. L. REV. 1, 13 (2009) ("[N]o formal political state has authority of a scope commensurate with modern global business. As a result, our world is one that virtually invites regulatory mismatches.").

[12] MIGA, *supra* note 2, at 35 (citing Maya Eden et al., *Sovereign Defaults and Expropriations: Empirical Regularities* (The World Bank, Policy Research Working Paper No. 6218, 2012)).

[13] Some observers might suggest that Argentina should have fallen into that category. *See* EM Ltd. v. Republic of Argentina, 473 F.3d 463, 466 n.2 (2d Cir. 2007) (recounting the history of Argentinian financial difficulties). However, as the recent financial crisis shows, sometimes the signs of risk exist but are ignored until it is too late. *See* Steve Charnovitz, *Addressing Government Failure Through International Financial Law*, 13 J. INT'L ECON. L. 743, 748 (2010).

[14] *See* Ahmed et al., *supra* note 6, at 40 (suggesting the use of sanctions, including litigation as a sanction).

[15] *See* Patrick Luff, *Risk Regulation and Regulatory Litigation*, 64 RUTGERS L. REV. 73, 113 (2011).

[16] *See id.*; *see also* John S. Coffee, Jr., *Litigation Governance: Taking Accountability Seriously*, 110 COLUM. L. REV. 288, 344-45 (2010).

defendants,[17] it has been largely ineffective in situations involving rogue debtors because of problems relating to the legal immunity of sovereigns and their assets.[18] As a result, some commentators have suggested that interstate negotiation constitutes the best if not only realistic means of addressing unanticipated sovereign defaults.[19]

However, another alternative may exist. In the last few years, investors have been experimenting with the possibility of using investment arbitration to address defaults on sovereign bonds.[20] Although there is still some debate about whether sovereign debt qualifies as an "investment" under various international treaties,[21] investment arbitration avoids a number of problems associated with regulatory litigation while nevertheless retaining some of its benefits. For example, states in investment arbitration are considered to have waived their immunity to suit.[22] Furthermore, enforcement of awards arising out of investment arbitration is typically easier than enforcement of judgments arising out of national courts.[23]

If investment arbitration is accepted as a regulatory mechanism similar to regulatory litigation, then investors may have found a workable solution to the problem of sovereign default.[24] However,

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17 *See* DEBORAH R. HENSLER ET AL., CLASS ACTION DILEMMAS: PURSUING PUBLIC GOALS FOR PRIVATE GAIN 119 (2000) ("[M]any corporate representatives whom we interviewed said that the burst of new class litigation has caused them to review financial and employment practices.").

18 *See* Lee C. Buchheit & G. Mitu Gulati, *Responsible Sovereign Lending and Borrowing*, 73 LAW & CONTEMP. PROBS. 63, 73 (2010) (suggesting that laws relating to sovereign immunity prohibit the seizure of state property to satisfy a judgment); Cross, *supra* note 3, ¶¶ 12.05, 12.19; Gelpern, *supra* note 7, at 1097.

19 *See* Buchheit & Gulati, *supra* note 18, at 69.

20 *See id.* at 86; Cross, *supra* note 3, ¶¶ 12.33-12.51.

21 *See* Cross, *supra* note 3, ¶¶ 12.28-12.44.

22 *See id.* ¶ 12.05; Michael Waibel, *Opening Pandora's Box: Sovereign Bonds in International Arbitration*, 101 AM. J. INT'L L. 711, 715 (2007).

23 *See* Cross, *supra* note 3, ¶ 12.05.

24 Although most commentators agree that international investment law operates as a regulatory mechanism, much of the analysis focuses on substantive issues, since that approach mimics conventional thinking regarding legislatively enacted regulation. *See* Benedict Kingsbury & Stephan W. Schill, *Investor-State Arbitration as Governance: Fair and Equitable Treatment, Proportionality and the Emerging Global Administrative Law*, *in* 50 YEARS OF THE NEW YORK CONVENTION 5, 10 (Albert Jan van den Berg ed., 2008); Stephan W. Schill, *Enhancing International Investment Law's Legitimacy: Conceptual and Methodological Foundations of a New Public Law Approach*, 52 VA. J. INT'L L. 57, 80-81, 85 (2011); Gus Van Harten & Martin Loughlin, *Investment Treaty Arbitration as a Species of Global Administrative*

regulatory litigation and arbitration are meant to operate as flexible responses to unforeseen events, and it is unclear how much flexibility is allowed in investment arbitration as either a procedural or substantive matter.[25]

This sort of philosophical split was evident in the preliminary award on jurisdiction rendered by the arbitral tribunal in *Abaclat v. Argentine Republic*, the first investment proceeding to address a default on sovereign bonds.[26] According to the claimants, "[t]he major threat to the efficiency of foreign debt restructuring [is] rogue debtors . . . . Consequently, opening the door to ICSID arbitration would create a supplementary leverage against such rogue debtors and therefore be beneficial to the efficiency of foreign debt restructuring."[27] The majority agreed that there was a "need for certain adaptations to the standard ICSID arbitration procedure," based on "the impossibility to anticipate all kinds of possible investments and disputes," and therefore allowed the dispute to move forward to the merits phase.[28] The *Abaclat*

Law, 17 EUR. J. INT'L L. 121, 124-27, 148 (2006). However, the question here is whether a particular process, in this case investment arbitration, might also act in a regulatory manner. *See* S.I. Strong, *Mass Procedures as a Form of "Regulatory Arbitration" -* Abaclat v. Argentine Republic *and the International Investment Regime*, 38 J. CORP. L. 259, 265 (2013) [hereinafter Strong, Regulatory Arbitration]. This analysis is facilitated by the fact that contemporary commentators have expanded the definition of regulation to include regulatory activity undertaken by private actors and other decentralized entities. *See* Colin Scott, *Privatization and Regulatory Regimes*, *in* OXFORD HANDBOOK OF PUBLIC POLICY 651, 653 (Michael Moran et al. eds., 2006).

25 *Compare* José E. Alvarez, *A BIT on Custom*, 2 N.Y.U. J. INT'L L. & POL. 17, 44 (2009) (suggesting need for flexibility in treaty interpretation), *with* Leon E. Trakman, *Foreign Direct Investment: Hazard or Opportunity?* 41 GEO. WASH. INT'L L. REV. 1, 3 (2009) (suggesting need for predictability in treaty interpretation). *See also* Daniella Strik, *Investment Protection of Sovereign Debt and its Implications on the Future of Investment Law in the EU*, 29 J. INT'L ARB. 183, 189-90 (2012) (discussing possible precedential power of *Abaclat v. Argentine Republic*); Strong, Regulatory Arbitration, *supra* note 24, at 313-16 (discussing procedural and substantive uncertainty).

26 *See* Abaclat (formerly Beccara) v. Argentine Republic, ICSID Case No. ARB/07/5, Decision on Jurisdiction and Admissibility (Aug. 4, 2011) [hereinafter *Abaclat* Award], *available at* http://italaw.com/documents/*Abaclat*DecisiononJurisdiction.pdf; Abaclat (formerly Beccara) v. Argentine Republic, ICSID Case No. ARB/07/5, Decision on Jurisdiction and Admissibility, Dissenting Opinion (Oct. 28, 2011) [hereinafter *Abaclat* Dissent], *available at* http://italaw.com/documents/*Abaclat*_Dissenting_Opinion.pdf.

27 *Abaclat* Award, *supra* note 26, ¶ 514.

28 *Id.* ¶ 519.

approach has subsequently been adopted, at least to a limited extent, by other arbitral tribunals facing defaults on sovereign bonds.[29]

The dissent in *Abaclat* strongly opposed any efforts "to create . . . leverage over sovereign debtors" through the use of "the tribunal's gap-filling powers under article 44 of the ICSID Convention," since neither the ICSID Convention nor the financial markets had ever contemplated such an approach.[30] The dissent also

> caution[ed] against the tendency of certain ICSID tribunals to consider any limitation on their jurisdiction . . . as an obstacle in the way of achieving the object and purpose of these treaties, which they interpret as being exclusively to afford maximum protection to investment, notwithstanding the legitimate interests of the host State.[31]

The dissent's concerns about the propriety of investment arbitration were not limited to a philosophical dispute about the flexibility of investment arbitration. The dissent also had a very practical problem in mind, namely the possibility that an expansive approach to investment arbitration in this context would trigger a more general backlash against investment arbitration.[32]

Concerns about a growing disenchantment with investment arbitration are not new. As state respondents have come to realize that investment arbitration constitutes a regulatory mechanism with real teeth,[33] some states have either withdrawn from or refused to enter into various investment treaties.[34] However, this

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[29] *See* Ambiente Ufficio S.p.A. v. Argentine Republic, ICSID Case No. ARB/08/9, Decision on Jurisdiction and Admissibility, ¶¶ 12, 423 (Feb. 8, 2013), *available at* http://www.italaw.com/sites/default/files/case-documents/italaw1276.pdf; Cross, *supra* note 3, ¶¶ 12.28-12.32.

[30] *Abaclat* Dissent, *supra* note 26, ¶ 265.

[31] *Id.* ¶ 272.

[32] *See id.*¶ 274.

[33] *See* Gary Born, *A New Generation of International Adjudication*, 61 DUKE L.J. 775, 843-44 (2012) (emphasizing investment arbitration's increasingly significant role in the resolution of international disputes).

[34] *See id.* at 843-44; Luke Eric Peterson, *In Policy Switch, Australia Disavows Need for Investor-State Arbitration Provisions in Trade and Investment Agreements*, INVESTMENT ARB. REP. (Apr. 14, 2012), http://www.iareporter.com/articles/20110414; Sergey Ripinsky, *Venezuela's Withdrawal from ICSID: What it Does and Does Not Achieve*, INVESTMENT TREATY NEWS (Apr. 13, 2012), http://www.iisd.org/itn/2012/04/13/venezuelas-withdrawal-from-icsid-what-it-does-and-does-not-achieve/.

approach is both relatively extreme and relatively rare. Instead, the real threat to the investment regime comes from more nuanced responses to the risk of broad financial exposure in investment arbitration.

At this point, states appear to have devised three possible ways of minimizing the likelihood of being named as a respondent in an arbitral proceeding involving sovereign debt. First, states may specifically exclude disputes involving sovereign debt from the scope of existing treaties or subject such matters to special treatment.[35] A number of these clauses already exist, although no tribunal has yet addressed one of these provisions.[36]

Analytically, this approach could generate a number of challenges. On the one hand, states are entitled to limit the scope of the treaties into which they enter. However, difficulties could arise if the exclusions conflicted with other principles of international law.[37] Practical and jurisprudential problems could also arise if the state in question was seeking to amend the terms of an existing treaty, since it is often difficult to alter international agreements once they are in force.[38]

Second, states could specifically exclude certain types of remedies, such as investment arbitration, from contracts associated with sovereign debt.[39] The need for an express waiver may seem anomalous, since arbitration is a creature of consent and most sovereign loan agreements do not currently include an arbitration provision.[40] However, investment arbitration involves a "standing offer" of arbitration from the state to all eligible investors pursuant to a bilateral or multilateral investment treaty or free trade agreement, which means that a qualified party can bring an investment proceeding even if the underlying contract does not

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35 *See* Cross, *supra* note 3, ¶¶ 12.45-12.51.

36 *See id.* ¶¶ 12.45-12.51, tbl. 12.1.

37 *See id.* ¶¶ 12.45-12.51; S.I. Strong, *Limits of Autonomy in International Investment Arbitration: Are Contractual Waivers of Mass Procedures Enforceable? in* CONTEMPORARY ISSUES IN INTERNATIONAL ARBITRATION AND MEDIATION: THE FORDHAM PAPERS 2013 (Arthur W. Rovine ed., forthcoming 2014) [hereinafter Strong, Waiver] (discussing how waivers of investment arbitration might be treated under international law).

38 *See* Strong, Waiver, *supra* note 37.

39 *See id.* (discussing three ways states could attempt to limit liability in investment arbitration).

40 *See* Cross, *supra* note 3, ¶ 12.02.

include an arbitration provision.[41]

It is unknown whether any state has attempted to insert a waiver of investment arbitration in a sovereign loan agreement. However, an explicit waiver of investment arbitration was recently proposed by the Republic of Colombia in a model concession agreement,[42] which suggests that similar language could be used in other contexts, including sovereign debt.

No arbitral tribunal has yet considered the validity of a contractual waiver of investment arbitration, and very little commentary exists regarding the enforceability of such provisions.[43] However, observers believe that these waivers would be extremely problematic, since states would be allowed "to reap the general benefits of signing investment treaties (in terms of reciprocity and reputation) without having to face up to the regulation and potential scrutiny that such treaties entail."[44]

Finally, states could include contractual restructuring clauses known as collective action clauses (CACs) in sovereign bonds so as to limit the possibility of holdout creditors bringing an investment action.[45] Although no tribunal has yet been asked to consider these sorts of provisions in the context of sovereign debt, some states have already adopted these sorts of provisions as a precautionary measure.[46]

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41 *See id.* ¶ 12.08, 12.15; Strong, Waiver, *supra* note 37.

42 The language was subsequently removed following objection from the international community. *See* Sebastian Perry, *Colombia Drops Treaty Claim Waiver Provision*, GLOBAL ARB. REV. (Dec. 13, 2013), http://globalarbitrationreview.com/news/article/32122/colombia-drops-treaty-claim-waiver-provision/; S.I. Strong, *Contractual Waivers of Investment Arbitration: Wa(i)ve of the Future?* 29 ICSID REV.-FOREIGN INVESTMENT L.J. (forthcoming 2014) [hereinafter Strong, Contractual Waivers] (on file with author).

43 *See* Paul Michael Blyschak, *State Consent, Investor Interests and the Future of Investment Arbitration: Reanalyzing the Jurisdiction of Investor-State Tribunals in Hard Cases*, 9 ASPER REV. INT'L BUS. & TRADE L. 99, 127 (2009) (discussing paucity of authority relating to waiver); Ole Spiermann, *Individual Rights, State Interests and the Power to Waive ICSID Jurisdiction Under Bilateral Investment Treaties*, 20 ARB. INT'L 179, 183 (2004) (discussing the concept of waiver of investment arbitration); Strong, Contractual Waivers, *supra* note 42 (analyzing issues relating to waiver of investment arbitration); Strong, Waiver, *supra* note 37 (discussing waiver in the context of class or mass claims).

44 Blyschak, *supra* note 43, at 148 (citation omitted).

45 *See* Waibel, *supra* note 22, at 713, 735-38.

46 *See* Cross, *supra* note 3, ¶ 12.33 (discussing a Greek law that retroactively inserted collective-action clauses into Greek sovereign debt instruments that could effectively bar sovereign debt claims of the type seen in *Abaclat*).

As the preceding suggests, questions relating to sovereign debt are extremely complicated, and it is impossible to address all relevant issues in an Essay of this magnitude. However, it is clear that the international legal community has much to consider in the coming years. Not only will tribunals have to parse through the precise language of the relevant treaties and contracts, they may also need to consider important policy issues such as who should bear the burden of the risk of loss.[47] On the one hand, many investors are relatively sophisticated and should perhaps be considered to be on notice of the possibility of rogue debtors.[48] Certainly the recent trend toward including sovereign default as an insurable political risk suggests that sovereign insolvency should no longer be considered an unanticipated event.[49] On the other hand, sovereign default remains a largely random occurrence, and may not possible for investors or insurers to protect themselves properly against such scenarios. Furthermore, it may not be just or economically prudent to allow states to act in bad faith, given the effect such behavior has on global capital markets.[50]

When considering these issues, it may be useful to consider research on regulatory litigation that discusses who is best placed to guard against particular sorts of risks.[51] Although such analyses are beyond the scope of the current Essay, they would likely shed a great deal of light on what is an extremely important issue in international legal and business circles.[52]

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47 *See Abaclat* Dissent, *supra* note 26, ¶ 270.

48 *See Abaclat* Award, *supra* note 26, ¶ 461.

49 *See* MIGA, *supra* note 2, at 46-47 (discussing empirical evidence concerning political risk calculation).

50 *See* Blyschak, *supra* note 43, at 148 (discussing effect of sovereign default on international investment).

51 *See* S.I. Strong, *Regulatory Litigation in the European Union: Does the U.S. Class Action Have a New Analogue?*, 88 NOTRE DAME L. REV. 899, 948-53 (2012) (considering how regulatory litigation operates in different regions).

52 *See* Waibel, *supra* note 22, at 757-89 (noting the importance of sovereign default issues to global economy).

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