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 policies1 as well as an increase in political instability in several regions.2

Although investors are routinely required to calculate financial

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risks, “political risk events are not easily predictable.” 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.”

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

Traditionally, states, markets and investors have attempted to

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.").
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 Gelpen, 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. 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. 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. All of these approaches also tend to be limited to cases where the possibility of sovereign default has been anticipated in advance.

However, there are other ways to address sovereign default. One mechanism, known as “regulatory litigation,” may be particularly useful, since it focuses on unanticipated risk. 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.” Although this device has been successful in cases involving corporate

10 See MIGA, supra note 2, at 37, 42 (discussing risk aversion in emerging economies); Iman Anabtawi & Stephen L. Schwarz, 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.”).


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).

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

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. Although there is still some debate about whether sovereign debt qualifies as an “investment” under various international treaties, 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. Furthermore, enforcement of awards arising out of investment arbitration is typically easier than enforcement of judgments arising out of national courts.

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. However,

17 See DEBORAH R. HENSLER ET AL., CLASS ACTION DILEMMAS: PURSUING PUBLIC GOALS FOR PRIVATE GAIN 119 (2000) (“Many 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; Gelpn, 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.


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.\textsuperscript{25}

This sort of philosophical split was evident in the preliminary award on jurisdiction rendered by the arbitral tribunal in \textit{Abaclat v. Argentine Republic}, the first investment proceeding to address a default on sovereign bonds.\textsuperscript{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.”\textsuperscript{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.\textsuperscript{28} The \textit{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. \textit{See} S.I. Strong, \textit{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. \textit{See} Colin Scott, \textit{Privatization and Regulatory Regimes, in Oxford Handbook of Public Policy} 651, 653 (Michael Moran et al. eds., 2006).


\textsuperscript{27} \textit{Abaclat Award, supra} note 26, ¶ 514.

\textsuperscript{28} \textit{Id. ¶ 519.}
approach has subsequently been adopted, at least to a limited extent, by other arbitral tribunals facing defaults on sovereign bonds.\textsuperscript{29}

The dissent in \textit{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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,\textsuperscript{33} some states have either withdrawn from or refused to enter into various investment treaties.\textsuperscript{34} However, this


\textsuperscript{30} \textit{Abaclat} Dissent, supra note 26, ¶ 265.

\textsuperscript{31} \textit{Id.} ¶ 272.

\textsuperscript{32} See \textit{id.} ¶ 274.

\textsuperscript{33} See Gary Born, \textit{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).

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. A number of these clauses already exist, although no tribunal has yet addressed one of these provisions. 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. 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.

Second, states could specifically exclude certain types of remedies, such as investment arbitration, from contracts associated with sovereign debt. 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. 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

35 See Cross, supra note 3, ¶¶ 12.45-12.51.
36 See id. ¶¶ 12.45-12.51, tbl. 12.1.
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.\textsuperscript{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,\textsuperscript{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.\textsuperscript{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.”\textsuperscript{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.\textsuperscript{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.\textsuperscript{46}

\begin{footnotesize}
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\itemSee id. ¶ 12.08, 12.15; Strong, Waiver, \textit{supra} note 37.
\itemBlyschak, \textit{supra} note 43, at 148 (citation omitted).
\itemSee Waibel, \textit{supra} note 22, at 713, 735-38.
\itemSee Cross, \textit{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 \textit{Abaclat}.
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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. On the one hand, many investors are relatively sophisticated and should perhaps be considered to be on notice of the possibility of rogue debtors. 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. 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.

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. 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.

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