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The U.S. and EU Debt Crises in International Law—A Preliminary Review

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International law from the mid-1990s onwards has undergone a remarkable transformation: through a growing web of international treaties, states have committed themselves to pay compensation to qualifying foreign investors for expropriation as well as unreasonable impairment of investments by state measures. What is more, in many of these treaties, states have consented to arbitrate disputes with the foreign investor internationally, rather than in their own courts. Treaty-based arbitrations have grown steadily in number and have led to awards in the hundreds of millions of dollars.

Three years ago, as the financial crisis in the United States unfolded, commentators asked whether measures taken by the U.S. government in response to the crisis would give rise to claims against the U.S. pursuant to its international investment treaties. So far, we are not aware of any such claims that directly arose out of the financial crisis.[1]

In the last few months, the potential for claims has been on the rise: the U.S. and European Union debt crises threaten to do significant damage to international investors. Debt repayment defaults are an obvious threat. Less obvious threats include the impairment of investments as the direct consequence of austerity measures, significant exchange rate interference by a state, as well as increased taxation, especially of commodities that are perceived to have allowed investors to reap windfall profits. This article will explore the protections that international investment treaties may provide to qualifying foreign investors against these risks.

Sovereign Default Risk

The U.S. and EU debt crises present many political risks, or "the probability that a host government will, by act or omission, reduce the investor's ability to realize an expected return on his investment."[2]

An obvious risk is default by states on their bonds. The U.S., notoriously, came perilously close to defaulting on its sovereign debt prior to the 11th hour raising of the debt ceiling on August 2. In the case of the U.S. debt crisis in particular, the cause for a default would not have been an *inability* to pay, but a political unwillingness to incur additional debt to fund previously approved appropriations.

Although the U.S. government avoided a default on its sovereign debt, not all EU member states appear to be faring similarly. On July 25, The Washington Post reported *Greece Default 'Virtually 100%'* on the basis of a Moody's assessment of the European rescue plan for that country. The Wall Street Journal reported as recently as September 6, that *Greek T-Bill Auction Completed But Default Fears Stay*.

Recent decisions applying international investment treaties provide international investors in sovereign bonds with possible treaty remedies in case of a sovereign bond default. The recent decision in *Abaclat and others v. Argentine Republic* is an example of bondholders claiming for compensation for sovereign defaults under international investment treaties.[3] This decision will be welcome news to holders of Greek bonds.

The *Abaclat* claim was originally filed on behalf of more than 180,000 Italian holders of Argentine sovereign bonds issued between 1991 and 2001 in 83 different bond offerings.[4] Argentina "defaulted by publicly announcing the deferral of over US$100 billion of external bond debt owed to both non-Argentine and Argentine creditors" on December 23, 2001.[5] In January 2005, Argentina launched an exchange offer which "provided to the beneficial owners of the roughly US$81.8 billion in eligible outstanding debt a choice of options from which to choose the form of their new debt. The bondholders could choose par bonds with the same principal but a lower interest rate than the non-performing debt, discount bonds with reduced principal but a higher interest rate, or quasi-part bonds with a principal and interest rate falling between the two other bond options."[6] The arbitration claimants did not participate in that exchange offer.[7] The claim seeks compensatory damages for Argentina's default and restructuring on sovereign debt.

Importantly, the *Abaclat* tribunal explained that in case of the Argentine default, there was more afoot than contractual non-payment risk. The bondholders were subject to political risk, as well. The tribunal stated:

> **It is undisputed that Argentina, as debtor of the bonds, has failed to perform its obligations under these bonds. Argentina may (or may not) thereby have breached contractual obligations towards Claimants or other owners of security entitlements; this question is not at stake here. What is, however, relevant is that Argentina justifies its failure based on the exceptional circumstances surrounding its public default and linked to its devastating financial situation at the end of 2001. The Emergency Law that Argentina enacted thereafter was a reaction to these circumstances and part of an attempt to redress the finances of Argentina.[8]**

The tribunal further established that sovereign bonds were "investments" for purposes of treaty protection and allowed bondholders to submit claims regarding the bonds to international arbitration under the treaty.[9]

The result achieved in *Abaclat* is not unique. An early arbitral decision dating from 1997 in *Fedax v. Venezuela* previously confirmed that holders of sovereign debt instruments purchased on the secondary market are investors.[10] Similarly, questions of government frustration of performance on private debt instruments was at issue in the *Alpha Projektholding v. Ukraine* decision.[11] Although a treaty-by-treaty analysis will be necessary to establish whether sovereign debt is excluded, investors can look to structuring investments through treaty jurisdictions to gain additional protection.

An issue of significance for the current crisis arising out of *Abacalat*: the claimants did not tender into the exchange offer but pursued claims instead. This is an important distinction, as participation in a tender may, under some circumstances, be considered as a waiver of existing legal rights. Before tendering into an exchange offer, bondholders therefore should consider their options with counsel.[12]

Austerity Measures

Sovereign default is not the only political risk arising out of the U.S. and EU debt crises. Austerity measures have been introduced throughout Europe. Austerity measures by a different name are currently discussed by a U.S. Congressional Super-Committee. Financial commentators suggest that additional austerity measures may be needed in Europe in order to right sovereign finances. Such austerity measures can directly impair investments by cutting expected funding for investment projects.

One example of a recent cut was the elimination of subsidies by EU governments for solar energy producers. Fundamentally, any technology project party financed through government-sponsored enticement programs may well fall victim to such measures.

Similarly, the U.S. government is currently contemplating austerity measures as part of spending cuts mandated by political developments in the U.S. House of Representatives. These measures have removed key subsidies for green energy projects, for example. In the U.S., reports suggest that spending cuts agreed to as part of the Super-Committee process will very likely include significant reductions for renewable energy production. Reports suggest that these reductions could deal a major setback to the entire industry.[13]

Such subsidies arguably created an incentive for investors to enter the green energy market upon the reasonable expectation that these subsidies would remain in place. Investors may argue that removing these subsidies, at least with regard to programs in EU member states, may violate international investment treaties.

Faced with changes to the tariff structure in the electricity sector in the wake of a financial crisis, investors in the past have sought recourse to international treaty protections. One example, again, is Argentina. Argentina made tariff adjustments, including price changes, in the power sector as a response to the Argentine financial crisis. These changes included payment of tariffs without a dollar peg, the modification of marginal pricing formulas and the introduction of fixed-price caps. These changes have led to successful investment treaty claims.[14]

Similar claims may well be possible against European states that have cut subsidies—and such claims are in fact currently pending against the Czech Republic.[15] In the U.S. context, it is not clear what kind of spending cuts will eventually be made and how they will affect foreign investment at this point.

As with sovereign default, the ability to present a claim with regard to austerity measures will depend both upon the specific wording of the treaty, as well as representations made by the government about the longevity of particular subsidies that have been cut as a result of such measures. Investors will likely be protected against austerity measures if they can prove a reasonable investment-backed expectation in the *status quo* for a significant additional period of time, best in the form of a concession or other agreement. To the extent that they cannot prove this, they likely would have to establish discrimination or a form of unreasonable conduct by the government to present a claim.

Tax Increases

The flipside of austerity measures is the potential for increased taxation. This taxation increase is especially present in the commodities field where governments seek out to share in "windfall profits." Governments further may eliminate permissible tax structures employed by large enterprises to reduce tax exposure for large projects. Especially if combined, such revenue increases could significantly reduce the profitability of international investments.

Several investor-state tribunals have looked at the question of windfall profits taxation.[16] An emerging view is that windfall taxation is not of itself in violation of international investment treaties. Frequently, tribunals look to investment agreements that would provide an expectation of fiscal stability as an additional factor in determining liability. In the absence of such an agreement, tribunals likely would also take into account the size of the tax, as well as its trigger point.

There are significant differences between treaties with regard to tax measures. In the tax context in particular, the determination whether a measure would violate international investment treaties will depend on the construction of the agreement. Investors should therefore seek to protect their investments ahead of time if they are in an at risk area for windfall taxation.

Exchange Rate Intervention

Finally, there is a significant exchange rate risk. Switzerland, for example, recently set a value ceiling for the Swiss Franc against the Euro in order to protect Swiss exports. This action by the Swiss government may affect the value of Swiss Franc-denominated debt, for example.

Intervention by states in the currency market was not unprecedented prior to the current debt crisis. That being said, the actions by Switzerland to protect further increases in valuation of the Swiss Franc are extreme. These measures may have a significant impact on Swiss Franc-denominated lenders—and parties who recently structured their investments through Switzerland specifically to avoid exchange rate risk posed by the debt crisis.

The mere fact of an exchange rate intervention is not enough to give private investors a right to claim against the Swiss government—or any other government pursuing similar policies. Investors would have to show that they hold an investment in Switzerland. They further have to show that the exchange rate intervention damaged their Swiss investment. A Swiss Franc-denominated loan likely would not have a sufficient nexus to Switzerland to be considered an investment in Swiss territory. But loans issued to, or through, Swiss entities may well.

As the U.S. and EU debt crises continue to unfold, and as further exchange rate intervention is possible, investors should carefully consider their legal options in response to such action.

Can States Plead Necessity as a Defense for Their Actions?

One key defense which international investors must expect if they pursue a claim against the U.S. or an EU member state with regard to the debt crisis is necessity or invocation of a so-called non-precluded-measures clause. Both defenses allow the state to avoid liability with regard to actions that were necessary in order to prevent disastrous and unforeseen consequences.

Argentina, facing a severe financial crisis, similarly invoked both defenses. Argentina has had mixed success with regard to its invocation of necessity as well as non-precluded measures clauses. Some tribunals have allowed the plea, others have rejected it. This difference in treatment between tribunals of the same fundamental circumstances has led to lively debate in the investment arbitration field.[17]

It can be expected that a plea of necessity by the U.S. or an EU member state would receive significant deference. That said, it is certainly a potential factor with regard to both defenses that the host state itself caused the underlying crisis to arise. In this respect, a debt crisis in the U.S. or the EU differs from a financial crisis such as the one experienced by Argentina: the U.S. or EU debt crises can be argued to be entirely political in making given that the state has exclusive discretion to spend or not to spend. With regard to such a crisis, it is less possible for a host state to argue that the crisis was principally caused by economic rather than political considerations.

Conclusion

International law may make available significant remedies to foreign investors affected by the current US and EU debt crises. The scope of protection will vary on a case-by-case basis, depending upon whether the investor is protected by an international investment treaty, the scope of that treaty and the specific measures taken by the state in question.

That being said, these rights may be helpful tools in structuring future investments in EU debt, as well as in protecting existing debt holdings.

NOTES

1. Some reports suggest that the first claim that relates to drying up of credit in the wake of the 2008 financial crisis is a claim against Peru in *Caravelí Cotaruse Transmisora de Energía S.A.C. v. Republic of Peru* (ICSID Case No. ARB/11/9). These reports state that "[l]ittle is known of the details of the claim except that it relates to Peru's response to the drying-up of Caravelí's credit lines in the wake of Lehman Brothers' crash." Alison Ross, "Tribunal in Place for Credit Crisis Claim" Global Arbitration Review; Sept. 1, 2011, available at http://www.globalarbitrationreview.com/news/article/29795/tribunal-place-credit-crisis-claim (last visited Sept. 8, 2011).
2. N. Stephan Kinsella & Noah D. Rubins, International Investment, Political Risk, and Dispute Resolution (Oceana: 2005), at 3.
3. *Abaclat and ors v. Argentina*, ICSID Case No ARB/07/5; IIC 504 (2011); Decision on Jurisdiction and Admissibility, dated August 4,

2011, available at www.investmentclaims.com (last visited Sept. 8, 2011).
4. *Abaclat*, at fn. 1, ¶¶ 50-51.
5. *Abaclat*, at ¶ 58.
6. *Abaclat*, at ¶ 77.
7. *Abaclat*, at ¶ 81.
8. *Abaclat*, at ¶ 320.
9. *See, e.g.*, Abaclat, at ¶¶ 361, 387.
10. *See, e.g., Fedax NV v. Venezuela*, ICSID Case No ARB/96/3; IIC 101 (1997), Decision on Jurisdiction; July 11, 1997, available at www.investmentclaims.com (last visited Sept. 8, 2011).
11. *Alpha Projektholding GMBH v. Ukraine*, ICSID Case No ARB/07/16; IIC 464 (2010), Award; Oct. 20, 2010, available at www.investmentclaims.com (last visited Sept. 8, 2011).
12. Michael D. Nolan & Frédéric G. Sourgens, What is a Distressed Investor to Do? An analysis of the potential implications in the current BIT regime of the sale of politically threatened investments, Venezuela: The battle of *Contract Sanctity vs. Resource Sovereignty (Special)* TDM 2 (2008).
13. *See, e.g., U.S. Debt Deal Kills Off Prospects of Renewable-Power Support*, available at http://climate-connections.org/2011/08/08/u-s-debt-deal-kills-off-prospects-of-renewable-power-support (last visited Sept. 8, 2011).
14. *See, e.g., Total SA v. Argentina,* ICSID Case No ARB/04/1; IIC 484 (2010), Decision on Liability; Dec. 21, 2010, available at www.investmentclaims.com (last visited Sept. 8, 2011); *National Grid PLC v. Argentina*, IIC 361 (2008), Award; Nov. 3, 2008, available at www.investmentclaims.com (last visited Sept. 8, 2011).
15. *See, e.g.*, "Czech Republic takes new approach as ECT claims loom," Global Arbitration Review; June 28, 2011.
16. *See, e.g., Paushok and ors v. Mongolia*, IIC 490 (2011), Award on Jurisdiction and Liability; April 28, 2011, available at www.investmentclaims.com (last visited Sept. 8, 2011); *Burlington Resources Inc v. Ecuador*, ICSID Case No ARB/08/5; IIC 436 (2010), Decision on Jurisdiction; June 2, 2010, available at www.investmentclaims.com (last visited Sept. 8, 2011).
17. The authors have prepared a forthcoming article on this topic entitled "The Limits of Discretion" to appear in the Yearbook on International Investment Law & Policy 2011.