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The international journal of commercial and treaty arbitration

NEWS

Time for more transparency on sovereign debt

05 May 2020

Lagos in Nigeria, one of the countries facing multibillion-dollar arbitration liabilities (Credit: Shutterstock)

In recent years, several countries have been on the receiving end of multibillion-dollar arbitration awards, without formally acknowledging these debts as part of their overall sovereign indebtedness. ***Starla Griffin*** *of Slaney Advisors, which advises on the sale of investor-state arbitration claims and awards, argues that it is time for this practice to stop.*

It is only a matter of time before a sovereign debt restructuring is materially affected by a country's arbitration liabilities. Perhaps Venezuela will be the test case. It is also increasingly possible that a country's arbitration debt burden could, itself, result in a full-blown debt crisis. The rise in sovereign arbitration liabilities is an issue that merits urgent attention from sovereign states, policymakers, rating agencies and bondholders alike, as these assets become a more significant portion of a state's debt stock. Now is the time to bring sovereign arbitration debt out of the shadows to prevent a new and unprecedented kind of debt crisis.

First published on the *Global Arbitration Review* website, 05 May 2020.

Arbitration awards are by their nature confidential. As a result, it is not always possible to determine with precision the extent of sovereign indebtedness that they have created. Nonetheless, several indicators suggest that the problem could be significant. Two awards that have recently come to light (ie, the *P&ID award against Nigeria* now standing at US$9 billion, and the *Tethyan award against Pakistan*, currently worth US$6 billion) suggest that a single arbitration award can bring about a material change to the debt profile of a sovereign. This is the tip of the iceberg. There is a strong pipeline of pending investor-state arbitrations with amounts in dispute that are large enough to materially impact the creditworthiness of the sovereigns in question. Moreover, states have entered into thousands of investment treaties, contracts and other instruments that give millions of counterparts the ability to sue them for very large amounts, which means that so long as foreign investment within these parameters continues apace, so too will disputes continue to accumulate.

At the moment, many countries consider their arbitration debt to be “contested” or “contingent” long after it is neither. As a result, it is often not properly disclosed in bond prospectuses, it is not included in debt sustainability analyses and it is not properly considered for ratings purposes. There are various reasons for this, but this lack of transparency only exacerbates the looming problem. By not disclosing arbitration liabilities, rating agencies may simply be ignoring a key aspect of a sovereign’s creditworthiness and creditors may, as a result, be mispricing risk. This lack of transparency may also impede a country’s ability to properly plan its borrowing or prepare for possible debt distress.

This article attempts to explain the issues at stake and present solutions to improve the system. In the first section, we explain why we expect arbitration-related liabilities will continue to accumulate and probably grow. We also outline specific characteristics of sovereign arbitration awards, which make them uniquely troublesome for sovereigns. And, we introduce the evolving market for arbitration assets, which is changing the nature of arbitration awards and the cadre of arbitration creditors.

Next, we outline the current approach to recognising and disclosing arbitration debt followed by sovereigns, the IMF, rating agencies and others, and explain why this approach is problematic; and, finally, we provide some ideas for addressing the many issues implicated by this cross-section of sovereign debt and international arbitration.

The increasing importance of sovereign arbitration debt

Available data suggests that the number of investment treaty arbitrations brought per year continues to increase, while the number of very large single awards, and costly cumulative awards against a single sovereign, are becoming more prevalent. The problem, of course, is that there is a lack of transparency with respect to this debt. The ICSID and UNCTAD sites capture the cases arising from investment treaties, but they do not include all disputes arising from private contracts. For example, the *P&ID* case against Nigeria would not have been listed on either site as that arose from a private contract. To make matters worse, because arbitration can take many years to complete and the awards being issued today are the result of procedures initiated many years ago, many states already have a sizeable pipeline of potential arbitration exposure that is making its way through the arbitration system but has not yet crystallised.

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In terms of liabilities, while these databases disclose the prevailing party, the award sums are usually confidential. Over time, however, this information may come to light when one or more awards are publicised. For example, we have discussed Nigeria (one award currently standing at US$9 billion) and Pakistan (one award currently standing at US$6 billion). Another example in the public domain includes the Republic of Congo, where one award of US$1.3 billion, and growing, represents 18% of that state's GDP. These are single awards.

Cumulative awards are also a concern. These arise from one triggering event that gives rise to multiple "doppelganger" cases. The first such trend happened when Argentina took a series of measures in the early 2000s that were designed to shift its public indebtedness from foreign to domestic currency. These measures resulted in a raft of investment treaty claims, some of which are still pending today. More recently, this same phenomenon was seen (with of course different triggering events) in Venezuela, Ecuador, Bolivia, Libya and Spain. In all cases, this tends to result in a "cascade" of awards against the sovereign that can add up to billions as more claimants bring their cases forward. Spain has cumulative award exposure estimated to be several billion dollars; Egypt has cumulative awards exceeding US$2 billion; and Venezuela is thought to have cumulative awards exceeding US$10 billion.

It is clear that sovereign arbitration debt can be particularly debilitating for developing countries, where one (or several) arbitration awards may represent a significant amount of external debt and potentially create debt distress. The fact that arbitration debt is nearly always dollar or euro-denominated means that it can significantly increase these countries' external debt burdens. For others, sovereign arbitration debt may seem insignificant in comparison to such country's external debt exposure to the international bond markets. For example, Argentina defaulted on US$93 billion of international bonds in 2001, while the arbitral awards which flowed from this economic crisis were a fraction of this amount. A key point to consider, however, is that while bond debts are routinely restructured (however imperfectly), arbitration debts have not yet been a part of a comprehensive debt restructuring. This has a dual impact because, first, arbitration creditors remain free to act unilaterally against a debtor even while it is negotiating a restructuring package with its other creditors. Second, arbitration creditors are not subject to anything like the collective peer pressure or actual collective action clauses that are used to compel bondholder agreement and facilitate bond restructurings. Without mechanisms to recognise, let alone restructure, arbitration debts as part of any framework to restart economic growth, they will continue to grow in size and threaten a country's return to economic health, particularly in light of the unique characteristics of arbitration debt discussed below.

Unique characteristics of sovereign arbitration debt

There are a number of characteristics of arbitration awards that make them particularly harmful to sovereigns if ignored. Chief among them is the "super-enforceability" that awards benefit from (as opposed to, say, defaulted sovereign bonds) by application of either the New York or Washington (ICSID) Conventions. As a result, they are extremely powerful.

To illustrate, a creditor holding a default judgment on a defaulted bond or loan governed by New York law will be required to take that judgment to a New York court and have it recognised before any enforcement action may be commenced against the debtor. This proceeding, which itself could take considerable time, would merely be the first instalment

in what often becomes a long-running saga, where the New York judgment is then taken to the various countries where the sovereign is believed to hold assets. Each instalment involves more expensive litigation, and more time. An arbitration creditor, in contrast, may commence enforcement action in any country that is a signatory of the ICSID Convention on the one hand, or the New York Convention on the other. Although in practice these proceedings also take time, the worldwide enforceability of arbitral awards allows creditors to move faster, and more comprehensively, against recalcitrant debtors. Furthermore, arbitration often benefits from worldwide enforceability from the date of decision on the merits (or very shortly thereafter) even if an action is launched to challenge the decision in some way.

A state may take an action to set aside the award, or in the case of ICSID, pursue an annulment proceeding. However, the grounds for set-aside and annulment are very narrow and primarily centre around jurisdictional questions. If either the set-aside or annulment is successful, the entire award may be cancelled. This is being played out now with the *Yukos* case, where the (approximately) US$50 billion award against Russia was set aside but has now been reinstated on appeal. While such actions may cause uncertainty in the short term, importantly, once a claimant successfully defends one of these actions, the award stands. The debt should no longer be considered contested or contingent at this stage, contrary to what appears to be the view of some sovereigns and other agencies. The claimant will still need to take active steps to enforce the award to recover payment from the sovereign, but the debt is real, just as debt contracted through a loan or bond issuance is real. To clarify, there is a distinction between an arbitration claim (which is necessarily contingent), an arbitration award (which is somewhat contingent because it can still be annulled, even if rarely), and a confirmed arbitration award where the only uncertainty is whether and when the creditor will collect. This is one key area where the disclosure of sovereign arbitration indebtedness needs to improve dramatically.

Another characteristic of arbitration debt is that it can come with higher interest rates than those seen on the bond market. Some of the largest awards we have seen have rates (sometimes compounding) ranging from 3% to 8% or higher. Ignoring these liabilities results in soaring amounts due to passing time. The *P&ID* case is a good example. The final award, which dates from 2017, was US$6.6 billion. It is now valued at US$9 billion.
This interest issue adds an additional imperative to an already serious issue, given that the principal amounts awarded can be high to begin with, given that these disputes often arise in the natural resources, energy or construction industries where significant sums are at stake.

Sovereign arbitration debt: an evolving trading market

There is a group of creditors who are ahead of the curve in recognising the value of arbitration claims as tradeable sovereign assets, similar to how early sovereign loan traders recognised the potential market for those assets in the mid-1990s. These investors provide an exit for successful claimants, who after years of protracted and expensive arbitration, are happy to sell all or a portion of the award (at a discount) in exchange for a cash pay-out. These investors are willing to wait for their payday or are more prepared to use their cash and expertise to recover amounts due than the original claimant. Either way, these investors recognise that they are buying sovereign debt (though not in the form of a loan or bond). Arbitration debt is becoming a distinct sovereign asset.

Current approaches to sovereign arbitration debt disclosure

While the international arbitration community needs little convincing that sovereign arbitration awards are legitimate debts, which become due and payable upon final decision, this is not necessarily how many sovereigns and others perceive them. For example, in February 2017, just weeks immediately following the issuance of the multibillion-dollar *P&ID* award, Nigeria issued a bond that failed to disclose that this liability had crystallised. In this bond issuance, which was eight-times oversubscribed, Nigeria raised $1 billion from international bondholders.

In the current system, sovereigns can try to have their cake and eat it. First, because it is notoriously difficult to enforce against a sovereign which does not recognise a debt, or even if it does recognise the liability, if it refuses to pay most enforcement and collection efforts end up in the courts. Once that happens, a recalcitrant sovereign can fall back on the inherent uncertainties of litigation to argue that the recoverability of the debt is "contingent" and need not, as a result, be disclosed. It is plainly wrong for sovereigns and ratings agencies to hide behind the fact that the outcome of enforcement action against a specific arbitration debt may be uncertain to argue that the arbitration debt itself is contingent or uncertain.

This becomes even more problematic if policymakers are either unaware of the debt, or not in a position to force the sovereign to acknowledge the debt, thereby allowing the debt to go unpaid. If the sovereign is not acknowledging the debt, it is not disclosing it to policymakers, rating agencies or other advisors that may be advising it on borrowing or structuring debt. Likewise, accurate information about a country's debt liabilities is not getting out to other investors who may be deciding to invest. All during this period of denial, arbitration debts are not vanishing. In fact, they can continue to accumulate interest and become a larger and larger problem.

This obfuscation may occur inadvertently or by design. We have often found that there may be a lack of coordination between the attorney general, who is usually involved in litigating an arbitration on behalf of a state, and other ministries within a country that would normally be involved in sovereign debt issues such as the finance ministry or debt management office. It can be politically embarrassing for one government agency to admit to another that it has overseen the unintended multiplication of a country's debt, or there may just not be a procedure for communicating, resulting in an unintentional lack of recognition. Most often, however, there is an element of not wanting to admit to the liability – to insist that an award is still contested even after a final decision has been rendered or an annulment procedure lost – that leads to a lack of acknowledgement.

Rating agencies get their information from the countries they rate so any lack of recognition or acknowledgement of an award by a country will be withheld from a rating agency as well.

The International Monetary Fund has some guidelines for debt reporting which apply to low-income countries, and include the possibility of reporting ICSID arbitration award debt in certain contexts. However, it allows these countries to exclude such debt to the extent that there is "a dispute with respect to the validity of a claim or the amount of a claim", and the IMF will always be reluctant to argue with the member country about this as it will want to remain objective. So long as a state can argue that an award is contested, it is not required to disclose it. The IMF relies on a country's reporting to execute a debt sustainability analysis

(DSA) that is then used for a number of purposes, including determining a country's eligibility for non-concessional financing. The non-reporting of these liabilities can have distortive consequences.

Suggestions to improve the system

We have presented below some suggestions for addressing the many issues implicated by this cross-section of sovereign debt and international arbitration. Initiatives to improve the BIT system, or radically change contractual relationships that give rise to these kinds of liabilities are outside the scope of this article but should certainly form part of the debate. Rather, we focus on capacity-building and transparency initiatives to help shine a light on these liabilities and provide suggestions for recognising and addressing these debts so that they do not result in unanticipated debt crises.

First, a great deal can be done in terms of capacity building at the country level, and with regard to sitting arbitrators. At the country level, attorneys general, debt management offices, and ministries of finance can put systems in place to monitor arbitration exposure, improve communication between relevant ministries, and enhance understanding of how arbitration debt affects other debt issues. More broadly, countries should develop a better understanding of their obligations pursuant to any investment treaties to which they are a party.

All country advisors, rating agencies and others involved in evaluating country debt exposure should familiarise themselves with the existing databases of pending arbitration cases and include questions about these in their due diligence. A centralised "traffic light" system could be developed that could then guide disclosure requirements. For example, a red disclosure would represent awards that are due and payable, which would require a sovereign to fully recognise the award, provide full disclosure in any fundraising documentation and inclusion in DSAs (amber awards could be subject to annulment, and green awards simply pending). This system could also include a materiality requirement, for example only including awards (single or cumulative) exceeding a certain percentage of GDP.

We are not suggesting that recognition of an award would result in automatic recovery. The cat-and-mouse game of enforcement will likely continue, and some sovereigns may conclude that they would rather enforcement-proof all of their revenues and evade their debts than pay an arbitration debt. To be clear, ignoring or refusing to pay will not make the debt disappear, but at least if it is properly disclosed, other potential creditors will know that there are competing interests on any assets.

Earlier recognition of the exposure could also help spur the development of market-based solutions to facilitate paying off the debt. For example, Argentina's compensation deal with Spain's Repsol (which had an arbitration claim against Argentina for the expropriation of Repsol's Argentine subsidiary YPF) is a good example of a market-driven solution (albeit to address political concerns). Here, Argentina issued roughly US$5 billion in government bonds to Repsol to settle the US$10 billion claim. Repsol was able to immediately sell the bonds into the market and Argentina was able to meet its obligations in a managed process. There are several countries with significant arbitral awards and sufficient market access that could benefit from this kind of securitisation solution. As these awards become more commoditised financial assets, this is likely to occur at some point, so it is worth developing

structures now. Countries with large potential exposures should also consider issuing debt that provides more flexible repayment structures (such as state-contingent debt like GDP-linked bonds), to protect from any economic shock stemming from a large arbitration award exposure

The onus to act responsibly should not rest solely with the sovereigns, however. It cannot simply be a case of “heads I win, tails you lose”, where the investors hold all the cards. At a minimum, two simple changes within ICSID could dramatically rebalance the tables. First, there needs to be some way of discouraging investors from bringing frivolous claims that could nonetheless chill investor appetite for a particular country while the cases are ongoing. In our opinion, there should be ways to make investors liable for costs if the awarded amounts are lower than a certain success threshold (to discourage inflated claims). Second, arbitrators who are chosen to sit at ICSID should be required to have some basic training in sovereign debt issues (perhaps administered by ICSID and the IMF) so that they can properly understand the impact of the decisions that they are called upon to make with respect to the debt profiles (GDP and other basic economic parameters) of the respondent countries, and thus more accurately contextualise any damages awards.

Sovereign arbitration debt will continue to grow and will increasingly form a material part of some countries’ debt profiles. Because of the unique characteristics of arbitration debt, and the mechanisms from which it arises, it is important for sovereigns and their advisors, policymakers, rating agencies and others to properly acknowledge and disclose these liabilities, and for all to consider how to address these liabilities. It is best to debate these issues before a debt restructuring is disrupted, or a debt crisis is created, as a result of this growing source of sovereign debt.

First published on the *Global Arbitration Review* website, 05 May 2020.