

**Testimony of Jonna Z. Bianco,  
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before the Subcommittee on Terrorism, Nonproliferation, and Trade,  
Committee on Foreign Affairs,  
U.S. House of Representatives**

**“Justice Delayed: Holding China Accountable for Its Sovereign Debt Defaults”**

**July 17, 2008**

**Introduction**

Mr. Chairman, Ranking Member Royce, and distinguished members of the Subcommittee, thank you for the privilege of appearing before the Subcommittee on Terrorism, Nonproliferation, and Trade to discuss a matter that merits your urgent attention: China’s failure to honor its sovereign debt obligations, and the impact of that failure on thousands of hard-working American citizens and their families who own defaulted Chinese government bonds. The Executive Branch has refused to hold China accountable for its obligations under these bonds, and therefore has failed to uphold the legal rights of our fellow citizens. Consequently, we have turned to Congress to redress this injustice and, with bipartisan support, have introduced resolutions in the House and Senate to call attention to China’s unlawful conduct.

**American Bondholders Foundation**

I am the President of the American Bondholders Foundation (“ABF”), which represents the claims of approximately 15,000 American families who hold defaulted sovereign-backed bonds that were issued by pre-Communist governments of China. The ABF was created in 2001 after officials at the Department of State, the Department of the Treasury, and the National Security Council advised that the U.S. Government would not take an active role in promoting the settlement of China’s bond defaults. While sympathetic to the plight of American

bondholders, these officials maintained that the bond default was a “private citizen’s matter” and that there were more important policy priorities for the United States to pursue with Beijing. They recommended that I work with the Foreign Bondholders Protective Council, a nongovernmental entity, to seek redress from the Chinese Government. Subsequently, I created the ABF and identified and contacted individuals throughout the United States who hold defaulted Chinese Government bonds, receiving their power of attorney for the settlement of these defaulted bonds.

It is essential for the Subcommittee to understand the human dimension of this international financial issue. The bondholders whom the ABF represents consist mostly of low to middle-income families, and many of the bonds held by these families have been passed down through generations. These bonds are held by individuals and working families – not by corporations, banks, or institutional investors. Calculating the value of debt obligations in the same manner as the U.S. Department of the Treasury, the bonds held by our fellow American citizens represent a financial patrimony now worth approximately \$260 billion. Ensuring that China meets its obligation to honor these bonds is therefore not only a matter of international justice; it implicates the financial well-being and future of thousands of Americans.

### **Brief History of China’s Default on Its Sovereign Debt Obligations**

Between 1900 and 1938, the Imperial and Nationalist governments of China, confronted by the need to raise capital to deal with dire domestic economic problems, issued tens of thousands of bearer bonds – valued at hundreds of millions of dollars – that were backed by the full faith and credit of the Chinese government. Most of the bonds held by American bondholders were issued between 1912 and 1938 and sold by international banks, primarily

HSBC and Deutsche Bank. These bonds also were promoted and sold in the United States through U.S. securities dealers, listed on U.S. securities exchanges, advertised in U.S. newspapers, and quoted regularly in financial journals. The bonds were sold to investors in the United States, Japan, and Europe, including U.S. servicemen in World War II who were encouraged to come to the aid of our then-ally, China. The most prevalent among the defaulted bonds held by American bondholders are the 1913 Chinese Government 5% Percent Reorganization Gold Loan Bearer Bonds, which matured in 1960.

From 1913 until 1939, the Government of China serviced its financial obligations under the bonds. In 1939, however, as financial conditions deteriorated amid the Japanese occupation of China, the Chinese Government ceased payments, prompting the default of the bonds. The Chinese Government, however, pledged its intention to resume service on the debts when economic conditions permitted.<sup>1</sup>

After the Communist Chinese overthrew the Nationalist government in 1949 and established the People's Republic of China ("PRC"), the new Communist regime refused to recognize the international bond obligations of the governments it succeeded and failed to renew payments on outstanding debt incurred by predecessor Chinese governments. In 1955, the PRC formalized its position and issued a written statement that it could not repay bonds previously issued by "the Kuomintang reactionary Government."

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<sup>1</sup> Letter from J. Brian Atwood, Assistant Secretary for Congressional Relations, U.S. Dept. of State, to the Hon Charles A. Vanik, Chairman, Subcommittee on Trade, Committee on Ways and Means, U.S. House of Representatives, Dec. 11, 1979 ("Atwood Letter").

In May 1979, as part of the U.S. Government's official recognition of the PRC as the sole government of China, the United States and the PRC entered into an Agreement Concerning the Settlement of Claims. The agreement provided compensation to U.S. persons who had suffered a taking of property by the Government of the PRC, but expressly did not encompass the debt obligations of the Chinese Government associated with bonds issued by predecessor regimes.<sup>2</sup> In February 1983, however, the Ministry of Foreign Affairs of the PRC issued an official *Aide Memoire* in which it formally and expressly repudiated its defaulted sovereign debt obligations, proclaiming that "the Chinese Government recognizes no debts incurred by the past reactionary Governments of China and has no obligation to repay them. It is a long-established principle of international law that odious debts are not to be succeeded to."<sup>3</sup>

### **China's 1987 Settlement with British Bondholders**

A substantial amount of defaulted Chinese Government bonds were held by British citizens. As a result, in 1986, the British Government imposed legal restrictions barring China and any of its state-owned enterprises from issuing debt instruments in British capital markets because of the PRC's refusal to honor debts incurred by Chinese governments prior to the 1949 Communist Revolution.<sup>4</sup> In June 1987, the British Government reached an agreement with the PRC in which the PRC agreed to a settlement with British citizens holding the 1913 5% Reorganization Gold Loan bearer bonds – the same bond issue held by many American

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<sup>2</sup> In a letter from the U.S. Department of State to Congress in December 1979, the State Department expressly noted that "the PRC has not repudiated the bonds . . . ." Atwood Letter, *supra* note 1. In April 1981, the U.S. Foreign Claims Settlement Commission determined that there was no record that the PRC had "affirmatively repudiated" the defaulted bonds. *In the Matter of the Claim of the Welthy Kiang Chen*, Claim No CN-2-015, Decision No. CN-2-066, entered as Proposed Decision on Oct. 17, 1979 and reaffirmed as Final Decision on April 1, 1981.

<sup>3</sup> U.S. Foreign Broadcast Information Service, China Daily Report, Feb. 9, 1983, at B-1.

<sup>4</sup> Yacik, *1841 Repudiation of Mississippi Bonds May Limit State's Issues in Foreign Markets*, The Bond Buyer, Sept. 16, 1986.

bondholders, including the ABF bondholders.<sup>5</sup> Thus, the PRC acknowledged its legal obligation to honor the bonds. At the same time, however, the PRC made a conscious decision to remain in selective, discriminatory default with respect to American and other non-British bondholders.

### **China's Persistent and Flagrant Default**

It is incontrovertible that China is in default on its sovereign debt obligations to American bondholders. First, the bearer bond certificates held by American bondholders expressly state on their face that “[t]hese obligations are intended to be binding upon the Government of China *and any Successor Government.*” (Emphasis added.) Second, it is well established, as a matter of international law, that a successor government is responsible for the payment of sovereign debt obligations of a predecessor government.<sup>6</sup> As a leading international jurist wrote in the 1920s, “[a] monarchy may be transformed into a republic or a republic into a monarchy; absolute principles may be substituted for constitutional, or the reverse; but, though the government changes, the nation remains, with rights and obligations unimpaired.”<sup>7</sup> The Restatement (Third) of the Foreign Relations of the United States provides that “[a] state is responsible under international law for injury resulting from . . . (2) a repudiation or breach by the state of a contract with a national of another state (a) where the repudiation or breach is (i) discriminatory;

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<sup>5</sup> *China, Britain Settle Claims*, New York Times, June 8, 1987; *Historical Debts Accord Clears Way for China to Eurobonds*, Xinhua General Overseas News Service, June 5, 1987

<sup>6</sup> See *Restatement (Third) of the Foreign Relations Law of the United States*, § 712(2) (1986); Bederman, *Creditors Claims in International Law*, 34 Int'l Law. 235, 250 (Spring 2000); Pieter H. F. Bekker, *The Legal Status of Foreign Economic Interests in Occupied Iraq*, American Society of International Law (July 2003); *Great Britain v. Costa Rica (Tinoco Case)* (1923) (holding new Government of Costa Rica bound by concessions and bank notes given by Tinoco, the former dictator of Costa Rica, to British companies), reprinted in United Nations, *Reports of International Arbitral Awards* (2006).

<sup>7</sup> *Great Britain v. Costa Rica (Tinoco Case)* (1923), reprinted in United Nations, *Reports of International Arbitral Awards* (2006).

or (ii) motivated by noncommercial considerations, and compensatory damages are not paid; or (b) where the foreign national is not given an adequate forum to determine his claim of repudiation or breach, or is not compensated for any repudiation or breach determined to have occurred.”<sup>8</sup>

Third, China’s refusal to honor its sovereign debt obligations violates its obligations as a member of the World Trade Organization – a membership that requires China to abide by accepted international legal norms and to accept the commercial and financial practices of the international trading and investment community. Fourth, as noted above, China affirmatively has conceded its debt obligations with respect to these bonds, and has entered into selective default status, by entering into the 1987 settlement with Britain regarding British holdings of defaulted bonds.<sup>9</sup> Fifth, the ABF has received reliable reports that the PRC has notified the Government of France that it intends to settle the claims of French citizens who hold the identical series of defaulted bonds held by American bondholders.

China’s evasion of its responsibility to repay its sovereign debt obligations stands in sharp contrast to how comparable bond defaults recently have been resolved. In 1986, for example, the Government of the Soviet Union settled the claims of British citizens who were

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<sup>8</sup> Restatement (Third) of the Foreign Relations of the United States, § 712(2) (1986).

<sup>9</sup> A 1981 decision by the Foreign Claims Settlement Commission of the United States also supports the view that the PRC is in default on its sovereign bond obligations. In that decision, the Commission found that it did not have jurisdiction over a claim against the PRC concerning bonds issued by the Kuomintang Government, on the grounds that the PRC had not repudiated its debt obligations. *In the Matter of the Claim of the Welthy Kiang Chen*, Claim No CN-2-015, Decision No. CN-2-066, entered as Proposed Decision on Oct. 17, 1979 and reaffirmed as Final Decision on April 1, 1981. That changed in 1983, however, when the PRC formally repudiated its debt obligation on the bonds.

holders of pre-1917 Russian Government bonds. In 1996, the Government of Russia settled the claims of French citizens who were holders of defaulted pre-1917 Russian Government bonds.

It is therefore clear that China has affirmatively and brazenly chosen to be in selective default status with respect to American holders of defaulted Chinese bonds, in flagrant disregard of its international legal obligations and the economic consequences of its actions for the thousands of American citizens waiting for justice from Beijing.

### **Violation of SEC Disclosure Requirements**

In addition to violating international legal standards, China and numerous state-owned and controlled Chinese enterprises (“SOEs”) are currently in violation of disclosure requirements under U.S. securities laws. Numerous Chinese SOEs participate in U.S. capital markets and constitute “issuers” under the Securities Act of 1933. *See* 15 U.S.C. § 78c(a)(8) (defining “issuer”).<sup>10</sup> Under Rule 10b-5, they are therefore prohibited from making disclosures to current and potential investors in filings with the Securities and Exchange Commission (“SEC”) that contain misstatements or omissions of material fact. *See* 17 C.F.R. § 240.10b-5. Under U.S. securities law, information is “material” if there is a substantial likelihood that a reasonable

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<sup>10</sup> Chinese SOEs listed on the Euronex Securities Exchange of the New York Stock Exchange include Aluminum Corp. of China Ltd.; China Eastern Airlines Corp. Ltd.; China Life Insurance Co. Ltd.; China Mobile (Hong Kong) Ltd.; China Netcom Group Corp. (Hong Kong); China Petroleum & Chemical Corp.; China Southern Airlines Co. Ltd.; China Telecom Corp. Ltd.; China Unicom; Guangshen Railway Co. Ltd.; Huaneng Power International Inc.; Jilin Chemical Industrial Co., Ltd.; PetroChina Co., Ltd.; Semiconductor Manufacturing International Corp.; Sinopec Shanghai Petrochemical Co., Ltd.; Suntech Power Holdings Co., Ltd; and Yanzhou Coal Mining Co., Ltd.. Chinese SOEs listed on the NASDAQ Securities Exchange include Aluminum Corp. of China; American Dairy; ASAT Holdings; Asia Payment Systems; AsiaInfo Holdings; Alpha Spacecom; Baidu.Com., Inc.; Beijing Med-Pharm Corp.; Brilliance China; China Automotive Systems; China Eastern Airlines; China Energy Ventures Corp.; China Cable and Communications; China National Offshore Oil; China Energy Savings; China Techfaith Wireless; China Telecom; Chinadotcom; China Unicom; China Netco; Chindex; Comtech Group; Ctrip.com; China Yuchai International; Deswell Industries; International Display Works; INTAC International; 51 Job, Inc.; China Finance Online; KongZhong Corp; eLong; Linktone; Ninetowns Digital World; Nam Tai Electronics; Netease.com; Pacificnet Inc.; Radica Games; Sina Corp.; Shanda Interactive; Sinopec; Sohu.com; Sinovac Biotech; Target Media; Tiens Biotech; Tom Online; UTStarcom; Watchdata System; Webzen; and Qiao Xing Telephone.

investor would find such information to be important in determining whether to purchase the applicable securities. See 17 C.F.R. § 230.405 (SEC Rule 405); id. § 240.12b-2 (SEC Rule 12b-2).

Because information about outstanding defaults by an issuer clearly would be important to a reasonable investor in deciding to whether to purchase a security from that issuer, China's selective repudiation of its sovereign debt to American bondholders is a material fact required to be disclosed in SEC filings by Chinese SOEs. By failing to acknowledge China's selective default status in SEC filings by Chinese SOEs, these filings therefore unlawfully contain omissions of material fact that are misleading to potential American investors. To correct these omissions, such filings must include a clear statement that the PRC has selectively repudiated the sovereign debt obligations included by predecessor Chinese governments, so that current and prospective American investors are on notice of the risks associated with investments in Chinese SOEs. American investors are entitled to know that the Chinese Government refuses to honor the sovereign full faith and credit obligations incurred by the established and internationally recognized governments of China preceding the Communist takeover in 1949. They are entitled to all information pertinent to an assessment of whether an investment in a Chinese SOE may be at risk. Yet the SEC filings by Chinese SOE's are devoid of any disclosure regarding China's selective debt repudiation regarding bonds issued by pre-Communist Chinese governments.

### **Artificially High Credit Ratings**

Ignoring evidence to the contrary, and in the absence of SEC filings containing required disclosure of China's selective debt repudiation, the Nationally Recognized Statistical Rating Organizations ("NRSROs") consistently accord artificially high ratings to long-term foreign



currency debt of the Chinese Government. Standard & Poor's and Fitch accord "A" ratings to Chinese long-term foreign currency debt, while Moody's accords an "A1" rating. Under the standards used by these same NRSROs, these ratings would be degraded if they took into account China's repudiation of its sovereign debt obligations and its selective default status. Standards & Poor's, for example, assigns an "SD" (Selective Default) rating to a debt obligor that has failed to pay one or more of its financial obligations when it came due, where Standards & Poor's determines that the obligor has selectively defaulted on a specific issue or class of obligations but will continue to meet payment obligations on other issues or classes of obligations in a timely manner. A "Selective Default" rating precisely describes the status of the Chinese Government concerning its selective default on government bonds held by American citizens.

### **The U.S. Government's Indifference to China's Debt Repudiation**

Despite the ABF's efforts, the U.S. Government has failed to pursue the issue of China's failure to honor its debt obligations to U.S. citizens in Washington's bilateral relations with Beijing. In 1979, the Department of State took the position that because China had not affirmatively repudiated its bond obligations, "the appropriate channel for seeking compensation remains the Foreign Bondholders Protective Council."<sup>11</sup> Notwithstanding China's subsequent and express repudiation of its debt obligations in 1983, however, the Department of State has still not elevated China's selective default status to a meaningful bilateral issue in U.S.-Chinese relations. Indeed, as recently as 2003, the Department of State continued to refer inquiries regarding China's defaulted payment of the bonds to the private, non-governmental Foreign

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<sup>11</sup> Atwood Letter, *supra* note 1.

Bondholders Protective Council.<sup>12</sup> The Department of the Treasury has expressed support in principle for American bondholders holding defaulted Chinese bonds, but has refrained from pursuing the issue with the Chinese Ministry of Finance.

Federal regulators have been equally feckless. In the last three years, the ABF repeatedly has petitioned the SEC to require disclosure of China's selective default status in filings with the agency, on the grounds that such information constitutes material risk information to which potential U.S. investors are entitled as a matter of law. Chinese SOEs continue to issue debt and equity offerings in U.S. capital markets. Yet the SEC refuses to take the necessary action to ensure that potential American investors in these offerings are apprised of China's longstanding default on its sovereign debt obligations.

### **Congressional Resolutions**

The failure of the Executive Branch to protect the interests of American citizens injured by China's repudiation of its debt obligations requires Congress to take action. Now pending before the House of Representatives and the Senate are two non-binding resolutions -- H. Res. 1179 and S. Con. Res. 78 -- which highlight the issue of China's selective default and call for greater transparency by China and its SOEs in their SEC filings. Both resolutions express the sense of Congress that China and its government-owned and controlled enterprises should be required to disclose information about the selective default status of Chinese bonds in prospectuses and filings with the SEC.

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<sup>12</sup> Letter from W. Michael Meserve, Acting Director, Office of Chinese and Mongolian Affairs, U.S. Dept. of State, to Marvin Morris, Jr., Aug. 13, 2003.

These resolutions represent small but critical steps forward in the quest for justice on behalf of American bondholders. The artificially high credit ratings assigned by the NRSROs perpetuate the cycle of China's indifference to its sovereign debt responsibilities. They give China an incentive to avoid a negotiated settlement with U.S. citizens regarding China's default on sovereign bonds held by U.S. citizens. And they provide "cover" to the SEC to forego holding China more accountable in SEC filings by the Chinese Government and Chinese SOEs.

### **Conclusion**

There is an adage in the law that "Justice delayed is justice denied." For the thousands of American citizens who are entitled to full and fair redemption of Chinese sovereign bonds, justice has been delayed far too long. We appreciate the Committee's attention to this important issue, and we urge the Committee's support for the pending resolutions.