STATE OF NECESSITY AND SOVEREIGN INSOLVENCY

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Abstract

This article explores the contours of the operation of a state of necessity under general international law in situations of sovereign insolvency. The central inquiry is whether a state can escape its responsibility for defaulting on or restructuring its debt contrary to its international obligations by invoking a state of necessity.

The article is structured in two main parts in a distinct manner. In the first part, I posit necessity as a secondary rule of international law and define sovereign debt and insolvency for the purposes of the article. Then, I turn to examine possible causes of action that could trigger the responsibility of debtor states for debt default or restructuring. Although not directly relevant to the core inquiry regarding the operation of the necessity plea, this discussion is of essence because of the stark underdevelopment of international law on sovereign insolvency. Hence, in this context, limiting the scope of the study to a secondary rule designed to preclude wrongfulness would be incomplete given the scarcity of primary rules that could give rise to international responsibility in the first place.

In the second part of the article the focus is shifted to necessity. The analysis begins with an overview of the early jurisprudence on the doctrine, proceeds with an examination of the case law of ICSID tribunals regarding the Argentine financial collapse of 2001 and then goes on to test the substantiation of the conditions of the necessity plea according to the Articles on State Responsibility for International Wrongful Acts in cases of sovereign insolvency. A third part wraps up the central findings and considers their policy implications for debtor states.

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STATE OF NECESSITY AND SOVEREIGN INSOLVENCY

A. Sovereign Insolvency and International Responsibility

I. The first part of this article examines the possible causes of action under general and conventional international law that could trigger a state's responsibility for defaulting on or restructuring its debt. It should be noticed at the outset that this examination is essential to the central inquiry of this study regarding the operation of the necessity plea in the context of sovereign insolvency. A state of necessity is a rule of international law that allows the invoking state to escape its responsibility for the commission of an internationally wrongful act.[1] In that sense, necessity does not constitute a substantive norm of international law that imposes upon a state an obligation to act in a certain way or to abstain from a particular behavior (primary rule), but rather a rule that regulates the circumstances under which the abrogation of such an obligation is excused (secondary rule).[2] Therefore, the commission of an international wrong is a *sine qua non* conceptual precondition for the operation of any secondary rule.

The scope of the necessity defense under general international law was the object of a controversial decision of the German Constitutional Court on the Argentine default of 2001 which held that a state cannot invoke a state of necessity *vis a vis* its private creditors to excuse the non performance of contractual obligations that are governed by domestic law.[3] The counterargument advanced by a strong dissenting opinion by judge Gertrude Labbe-Wolff in that case was that necessity can operate independently from its customary origin given that it is also

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[1] According to article 25 of the ILC Articles on State Responsibility for International Wrongful Acts (ASRIWA), "Necessity may not be invoked by a state as a ground for precluding the wrongfulness of an act not in conformity with an international obligation of that State unless the act:
(a) is the only way for the State to safeguard an essential interest against a grave and imminent peril; and
(b) does not seriously impair an essential interest of the State or States towards which the obligation exists, or of the international community as a whole.
In any case, necessity may not be invoked by a State as a ground for precluding wrongfulness if:
(a) the international obligation in question excludes the possibility of invoking necessity; or
(b) the State has contributed to the situation of necessity.

Article 27 ASRIWA reads, "The invocation of a circumstance precluding wrong- fulness in accordance with this chapter is without prejudice to:
(a) compliance with the obligation in question, if and to the extent that the circumstance precluding wrongfulness no longer exists;
(b) the question of compensation for any material loss caused by the act in question.

[2] This is the view supported by the International Law Commission. *See* ASRIWA at para.1.

[3] Joined Case Nos. 2 BvM 1-5/03 & 2 BvM 1-2/06. 60 NEUE JURISTISCHE WOCHENSCHRIFT 2610 (2007). Available at <http://www.bundesverfassungsgericht.de>.
Bundesverfassungsgericht (Federal Constitutional Court of Germany), May 8, 2007.

a general principle of law recognized in most municipal legal orders.[4] Many commentators subsequently subscribed to the approach of the dissenting judge of the Karlsruhe court.[5] In fact, the view of judge Wolff is closely connected with the proposition of the existence of a primary rule of "financial necessity" independent of that codified by article 25 of the ILC's Articles on State Responsibility for the Commission of Internationally Wrongful Acts - hereinafter ASRIWA-.[6]

Whereas the exploration of whether a primary rule of financial necessity constitutes *lex lata* in international law can be reserved for a later study, it can be fairly said that necessity has indeed deep routes in most legal systems[7] and it could be thereby characterized as a general principle of law within the meaning of Article 38(1)(c) of the Statute of the International Court of Justice. That, nevertheless, does not alter its character as a secondary rule of international law, and as such, a violation of a primary rule remains a necessary condition for its operation. This is so because even in municipal legal orders necessity still functions as an exculpation for unlawful conduct regardless of the absence of a distinction between primary and secondary norms that

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[4] Dissenting opinion of judge Gertrude Labbe-Wolff in Joined Case Nos. 2 BvM 1-5/03 & 2 BvM 1-2/06. 60 NEUE JURISTISCHE WOCHENSCHRIFT 2610 (2007).

[5] Beate Rudolfand Nina Hiifken, *German Federal Constitutional Court case note: Argentinean debt crisis and the defense of necessity under public international law* 101 American Journal ofInternational Law 857 (2007), Stephan W. Schill and Yun-I Kim *Sovereign Bonds in Economic Crises: Is the Necessity Defense Under International Law Applicable to Investor-State Relationships? A critical analysis of the decision by the German Constitutional Court in the Argentine bondholder cases* in YEARBOOK OF INTERNATIONAL INVESTMENT LAW&POLICY 2010-2011 OUP.

[6] This view arguably finds support in the Basis of Discussion No. 4 submitted by the Preparatory Committee to the Council for the International Law Codification Conference (The Hague, March 13, 1930), according to which:

"A state incurs responsibility if, without repudiating a debt, it suspends or modifies the service, in whole or in part, by a legislative act, unless it is driven to this course by financial necessity".

Also the early jurisprudence concerning cases that dealt with necessity which will be analyzed below -pages 23-27- could be also viewed as evidence for the existence of a primary rule of financial necessity. Perhaps the oldest case that makes reference to a "crude" rule pursuant to which states are absolved from responsibility for paying their foreign creditors in case of extreme financial difficulties comes from a 19th century decision of the English Court of Appeals in *Twycross v Dreyfus* (5 Ch. D. 605 (1877), 36 L.T.R. 752), where it was held that "[e]verybody knows that the first engagement a government contracts to pay out of its own revenues is the engagement necessary to continue its own existence as a government to pay for its military and civil services to any extent the government thinks necessary".

For the existence of a primary rule of financial necessity, see also Sarah Heathcote *Circumstances Precluding Wrongfulness: Necessity* in THE LAW OF INTERNATIONAL RESPONSIBILITY James Crawford, Alain Pellet, Simon Olleson Oxford University Press (2010) at 501 [hereinafter, Heathcote *Circumstances Precluding Wrongfulness: Necessity*].

[7] Addendum-Eight Report on State Responsibility by Mr. Roberto Ago, Special Rapporteur - The Internationally Wrongful Act of the State, Source of International Responsibility (part 1) [hereinafter Ago Report] at 47-48.

exists in international law.[8] Accordingly, the acceptance of a state of necessity as a general principle of law does not preempt the inquiry for the identification of a violation of a primary rule of international law.[9]

Therefore, the decision of the German Constitutional Court should be criticized because it did not inquire whether the Argentine default and debt restructuring triggered the international responsibility of the country, but instead it adopted the dogmatic position that a state of necessity could not be accepted under any circumstances to excuse the non performance of obligations of a state towards its private creditors.[10] As analyzed below, however, this position corresponds to a parochial dualist perception that does not appreciate the significant overlap between domestic and international law.

A different question though that relates to the availability of the necessity defense in proceedings before municipal courts is the institutional capacity of them to ascertain the legality of other states' acts on the basis of international law. While the evaluation of the conduct of foreign states pursuant to the forum state's domestic law is commonplace, the sovereign equality of states poses limitations to the ability of a municipal court to determine whether another state acted according or contrary to its international obligations.[11] This is indeed a fundamental issue, that could limit the practical significance of the discussion about the invocation of a state of necessity in cases of sovereign insolvency, especially in light of the fact that the great bulk of legal disputes regarding sovereign debt arise before domestic courts. Still, a deferential stance by domestic courts based on principles of sovereign equality and comity will not always be a

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[8] It should be noted, however, that at least in common law jurisdictions a necessity defense does not preclude the unlawful character of an act or omission, but rather forgives its author. Heathcote *Circumstances Precluding Wrongfulness: Necessity* at 494. For the debate of whether necessity under international law constitutes a plea of exculpation or excuse *see* Vaughan Lowe *Precluding Wrongfulness or Responsibility: A Plea for Excuses* EJIL (1999) Vol.10 No.2 405-411.

[9] For the purposes of the present article it will be assumed that the conditions of the necessity plea under international custom and as a general principle of law are those expressed in article 25 ASRIWA. It should be noted, however, that international custom and general principles of law constitute separate sources of international legal obligations, and to the extent that a certain rule originates from both sources, it is possible that its operation will be subject to different, and possibly conflicting, conditions. This complexity is the result of the nature of international law as a fragmented legal system, involving multiple normative sources. The question of how to resolve potential conflicts between rules originating from different normative sources of international law is outside the scope of the present study.

[10] The approach of the Constitutional Court is also in sharp contrast with the view of the International Law Association on this matter, according to which: "In terms of the basic fabric of international law, it would be surprising if an individual or institution were to receive a higher degree of protection than a state. In general, aliens will enjoy only a minimum standard of protection, whereas the rules on the relationship between States reflect the principle of sovereign equality. Moreover, the rationale underlying the concept of necessity contains nothing to justify providing the debtor State with less protection against an alien than against another State. At least in the absence of an express stipulation to the contrary, it thus should not be assumed that a debtor State has stricter obligations, in a state of necessity, vis-d-vis an alien than against another State". ILA Committee on International Monetary Law, Warsaw 1988, at p. 431-432.

[11] Andre Nollkaemper *Internationally Wrongful Acts in Domestic Courts* 101 Am. J. Int'l L. 760 2007 at 775. According to the writer, "The court's determination may or may not be shared by a court in a different jurisdiction or an international court but, as a result of the fundamental starting point of sovereign equality, will have no automatic legal consequences for the alleged wrongdoing state".

given, while, as it will be discussed later, an important trend towards a shift from private law litigation before municipal courts to international arbitration may be *ante portas* for sovereign debt disputes.

Before further proceeding to identify treaty and general international law rules that could trigger international responsibility in cases of sovereign insolvency, it is necessary to define the somehow abstract terms of sovereign debt and insolvency for the purposes of the present study.

Sovereign debt covers the totality of a state's monetary obligations, comprising a variety of liabilities such as national or international debt securities, debt owned to international financial institutions or to other sovereign states, trade debt owed to suppliers of goods and services and also administrative liabilities like the salaries of the civil service.[12] Importantly, private debts can be explicitly or implicitly guaranteed, thereby adding a significant burden to a state's overall indebtedness. This indeed became almost omnipresent in the aftermath of the financial crisis when huge amounts of private debts "migrated" from the balance sheets of banks and financial firms to those of states.

The classical categorization among these different classes of debt, and the most important from an international law perspective, is between external and domestic debt. A debt would be classified as external if certain conditions are met: typically, the debt is expressed in foreign currency, is governed by some external law and is subject to an external jurisdiction; also it would be probably payable abroad and owed to a foreign creditor.[13] However, the relative gravity of each of these factors is in flux and the classification of certain debt obligations poses difficulties.[14] Over and above the other criteria mentioned, what is crucial from an international law standpoint is the nationality of the creditor. Consequently, the focus in the following lines will be on external sovereign debt, to be understood as debt held by foreign natural and juridical persons.

Another important distinction is that between public and private sovereign debt and refers to the relevant capacity of a creditor as a person under private or public (international) law. Thus, a series of Argentine bonds held by German pensioners, for instance, is part of Argentina's external private sovereign debt, whereas the loans that the Greek state has contracted in 2010 with the International Monetary Fund can be characterized as external public sovereign debts[15]. The present study will examine default on private (external) sovereign debt, as the most

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[12] International Law Association Sovereign Insolvency Study Group (Hague Conference 2010) at p.9 [hereinafter ILA Report 2010].

[13] *Id.*

[14] The sovereign debt of Eurozone members for instance is predominantly expressed in Euros, which is considered as the national currency of these states. Euro's characteristics, however, resemble those of a foreign currency as Eurozone members have given away important aspects of their monetary sovereignty.

[15] Technically, the transactions between the IMF and its member states are not characterized as loans, but as "exchanges of assets" (IMF members requesting financing deposit their own currency in exchange for hard currency). See Lex Rieffel *Restructuring Sovereign Debt - The Case for Ad Hoc Machinery* (Brookings Institution Press 2003) at 32.

challenging questions regarding state responsibility and the operation of the necessity plea are raised in cases where the relationship does not fall into the traditional interstate public international law paradigm. Thus, the conclusions reached will be applicable *a fortiori* in cases of external public sovereign debt.

In economic parlance, insolvency refers to a situation where the liabilities of a corporation exceed its assets.[16] This definition is imperfect however in the context of sovereign debt, as a state can, at least theoretically, create unlimited income through taxation and thus its assets may not be exhausted. In practice, a country is considered insolvent when it is not able to pay its debts as they fall due -or more accurately to roll over its debt, that is to secure new financing to discharge existing liabilities.[17] A state that finds itself in a similar situation in fact has three -not mutually exclusive- options in order to deal with it; it can ask for a loan from the IMF or other willing creditors of the official sector[18], it can reduce its debt burden through a consensual agreement with its creditors (restructuring), or default on due payments. The present article is concerned with the last two possibilities, that is sovereign debt restructuring and default (sovereign insolvency *stricto sensu*).

Sovereign debt restructuring refers to the reduction of the value of a country's public debt that is achieved on a voluntary basis between the state and its creditors.[19] The voluntariness of the process, however, does not mean that international law is irrelevant. As it is discussed below, sovereign debt restructurings involve techniques that may be consistent with the contractual undertakings of the debtor state, but could still violate its obligations at the international level.

Sovereign default, on the other hand, is a term of art that is usually employed in common parlance invariably to describe different situations of sovereign insolvency (a "bailout" loan, a debt restructuring or an actual default). As a matter of law, an event of default will be described in detail in a relevant clause of a bond or other sovereign debt instrument and will be interpreted according to the proper law of contract (usually stipulated in a choice of law clause). Failure to make an interest or amortization payment on a bond issue, a violation of a *pari passu*, cross-default or negative pledge clause or even expulsion from the IMF[20] will usually give creditors -

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[16] This definition corresponds to the so-called "balance-sheet" test.

[17] ILA Report 2010 at 8. It should be noticed that in domestic currency denominated debt a country may never be considered insolvent as it can always devalue and "inflate its way out of debt".

[18] The term "official sector" in the context of sovereign debt refers to states, international organizations or informal creditor groups comprised of states (the Paris Club) that are involved in one way or another in the resolution of sovereign debt crises. The official sector is contrasted to the private sector, which includes the sovereign's private lenders.

[19] According to Sturzenegger and Zettelmeyer the term refers to "any changes in the originally envisaged payments, either after a default or under the threat of default". Sturzenegger and Zettelmeyer DEBT DEFAULTS AND LESSONS FROM A DECADE OF CRISES (MIT Press) at 3.

[20] Stephen Choi, Mitu Gulati, Eric Posner *Political Risk and Sovereign Debt Contracts* John M.Olin Law & Economics Working Paper. No. 583 (2d Series) The University of Chicago School of Law at p.16.

either individually or collectively- the right to accelerate the full amount owed under a bond's terms.

Repudiation of sovereign debt constitutes the most profound and less common case of default. Excluding instances of odious or otherwise illegitimate debts, repudiation is characterized by the subjective element of non acceptance of the binding nature of an obligation.[21] This element may be communicated explicitly by the defaulting state or remain concealed but be inferred by the overall conduct of the state towards its creditors. It could be said therefore that repudiation in fact constitutes a specialization of the concept of expropriation in the context debt obligations.[22]

The stream of payments to creditors may be also inhibited due to actions of the debtor state regulating its currency. In case of debt denominated in the sovereign's own currency the major risk for creditors (especially foreign ones) is that of devaluation that could effectively dilute their claims, even in the absence of default. For foreign currency debt, the imposition of exchange controls or monetary redenominations/conversions by the debtor state could preclude payment in the prescribed currency, thereby triggering an event of default.

The adoption of a loose monetary policy and broad regulations affecting its own currency are crucial aspects of a state's monetary sovereignty and as such any losses suffered by creditors due to them will be generally considered more tolerable than those caused in instances of isolated defaults. A state will be generally free to inflate its way out of debt through a devalued currency in the absence of contractual provisions safeguarding against such risk in the form of gold clauses that were commonplace in sovereign bonds in the past but not so anymore.[23] Exchange controls that are consistent with the IMF articles of agreement will be enforceable in every IMF member state, thereby essentially legitimizing a sovereign default that took place

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[21] Edwin Borchard STATE INSOLVENCY AND FOREIGN BONDHOLDERS (Yale University Press, 1951) at p. 129 [hereinafter Borchard *State Insolvency*].

[22] Celebrated cases are the repudiation of the Soviet Government of nearly $20 billion of Czarist debt, the Portuguese and Mexican non recognition of the debts contracted by Dom Miguel and Maximilian respectively. The US states of Mississippi, Florida, Alabama, N &S.Carolina, Georgia, Louisiana, Arkansas and Tennessee also repudiated various debts in the middle of the 19th century. Borchard *State Insolvency* at 129.

[23] Borchard *State Insolvency* at 136-138.

because of restrictions on the export of foreign currency.[24] Even conversion of debts from foreign to devalued domestic currency would not violate international law, to the extent that compelling reasons of public interest are present and in the absence of unjustified discrimination among creditors.[25]

Regardless of the facts that gave rise to it, default will be understood in the following lines in a narrow sense, as a violation of a contractual clause stipulating an event of default, that is, essentially, as a breach of contract.

II. As a sovereign default will be legally "translated" into contractual default, at a first level, the inquiry could be framed in a generic manner as under which circumstances a breach of a state contract with a foreigner constitutes an internationally wrongful act involving the responsibility of the state. Failure to make good on the contractual commitments undertaken by the state would no doubt constitute a *prima facie* violation of the municipal law governing the contract, but could be irrelevant as a matter of international law. The separability of legal obligations

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[24] According to Section 2 of Article VIII of the IMF Articles of Agreement, "subject to the provisions of Article VII, Section 3(b) and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions. Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member. In addition, members may, by mutual accord, cooperate in measures for the purpose of making the exchange control regulations of either member more effective, provided that such measures and regulations are consistent with this Agreement". With regard to sovereign debt defaults incurring as a result of exchange controls, the default should relate to "current international transactions". According to article XXX (d) of the IMF Articles of Agreement, "payments due as interest in loans" or "payments of moderate amount for amortization of loans" are considered current international transactions, and as such sovereign debt defaults come under the ambit of article VIII. What is more contested, however, is whether credit agreements qualify as "exchange contracts". In the UK and US jurisdictions exchange contracts have been interpreted narrowly so as to exclude credit arrangements. In the UK in particular, the Court of Appeals in *Wilson Smithett & Cope Ltd. v. Terruzzi* (1976) held that article VIII is only applicable in cases involving contracts for the exchange of currencies *see* Christopher Greenwood and Hugh Mercer *Considerations of International Law* in Barry Eichengreen and Richard Portes CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS Center for Economic Policy Research at 112 and Joseph Gold "*Exchange Contracts", Exchange Control, and the IMF Articles of Agreement: Some Animadversions on Wilson, Smithett&Cope Ltd. v. Terruzzi* 33 Int'l & Comp. L.Q. 777 1984. French courts, however, have interpreted "exchange contracts" more liberally in a way that would include state loans *see* Greenwood and Mercer at 111. In cases where article VIII is not found to be applicable, it will depend on the particular forum whether the exchange controls adopted by the debtor state will be given extraterritorial effects. As most foreign currency denominated debt will be governed by an external law and will be payable abroad it is likely that unilaterally imposed exchange controls will not be upheld *see* ILA Report 2010 pages 21-22.
The case of the imposition of exchange controls that affect sovereign debt payments incidentally should be distinguished from the qualification of a sovereign default *per se* as a form of an exchange control. In that later case, it will be also necessary to assume that a sovereign debt default constitutes a "restriction on the making of payments and transfers for current international transactions".

[25] In the case of *Continental Casualty Company v. The Argentine Republic*, ICSID Case No. ARB/03/9 (hereinafter *Continental)* the tribunal absolved Argentina from responsibility with regard to the "pesification" (forced conversion of obligations denominated in US dollars to liabilities expressed in Argentine pesos) of its bonds. See at paras 211-214.

assumed at the domestic and international level is well established[26] and boils down to the fact that what is wrong under international law may be right under national law and vice versa[27].

On the other hand, the strict dualist perception according to which the domestic and international legal orders are seen as parallel lines that never overlap each other failures to grasp the complexity of various legal relationships that may be established under municipal law, but can be of important regulatory concern at the international level. Indeed, this was the view of Sir Hersch Lauterpacht in his separate opinion in the *Norwegian Loans* case according to which "[A] dispute may be essentially within the national jurisdiction of a State while being at the same time a dispute concerning a question of international law."[28]

IIa. In the context of state contracts with foreigners, the relevant question of international law will be whether the treatment of private law rights by the state is consistent with its international obligations. Whereas breach of contract has been traditionally perceived as non contrary to general international law *per se*,[29] governmental interference that reaches a certain level of intrusiveness with contractual rights may violate the minimum standard of treatment that should be accorded to the property of foreigners. Indeed, customary international law protects acquired rights under contract by extending to them the protection offered to tangible property.[30]

Alas, the precise content of the "international minimum standard" is rather elusive, making its substantiation in a particular case problematic as a practical matter.[31] Still, international jurisprudence has contributed to its development by attaching to it an obligation to act in good faith and abstain from arbitrary behavior that is contrary to a sense of juridical

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[26] According to Article 3 of the ASRIWA, "The characterization of an act of a State as internationally wrongful is governed by international law. Such characterization is not affected by the characterization of the same act as lawful by internal law". In the *ELSI* case the International Court of Justice held that "[c]ompliance with municipal law and compliance with the provisions of a treaty are different questions. What is a breach of treaty may be lawful in the municipal law and what is unlawful in the municipal law may be wholly innocent of violation of a treaty provision." *Elettronica Sicula S.p.A. (ELSI)* (U.S. v. Italy), 1989 ICJ REP. 15, 51, para. 73.

[27] Andre Nollkaemper *Internationally Wrongful Acts in Domestic Courts* p.761.

[28] *Certain Norwegian Loans*, France v. Norway, Judgment, 1957 I.C.J. 9 (July 6) Separate Opinion of H.Lauterpacht at 42. Also, according to Professor Jennings, "[T]here is nothing in the structure of international law and nothing in the relationship between international law and municipal law that inhibits the recognition of international law remedies which relate directly to the contract". Chittharanjan Amerasinghe *State Breaches of Contracts with Aliens and International Law*, 58 Am. J. Int'l L. 881 1964, p.883 (hereinafter, Amerasinghe *State Breaches*).

[29] ASRIWA Article 4, para.6. Amerasinghe, *State Breaches* p.886.

[30] *Wena Hotels Limited v Egypt*, Award, ICSID Case No ARB/98/4 at para 98, *Amoco International Finance Corporation v Iran and ors*, Partial award, Award No 310-56-3, (1988) at para 108, *Shufeldt Claim* (USA v. Guatemala), American-Venezuelan Mixed Claims Commission, II RIAA 1079-1105 (1930) Permanent Court of Arbitration *Norwegian Shipowners' Claim* (Norway v United States), 13 October 1922, I RIAA 307-346 at 334, *Rudloff Case*, Decision on Merits, IX RIAA 255-261 (1903-1905).

[31] According to Borchard, however, "[I]t is probably less difficult to apply than to define these principles (relating to the international minimum standard)". Edwin Borchard *"The Minimum Standard" of the Treatment of Aliens* 38 Mich. L. Rev. 445 1939-1940 at 460.

propriety.[32] Furthermore, with regard to expropriation, the minimum standard is believed to require the following: a) the expropriation must be made for public purpose; b) it must not discriminate against foreigners; and c) it must be accompanied by compensation.[33]

Another question that needs to be addressed is whether there are rules of general international law that provide special protection to sovereign debt, going beyond the minimum standard of treatment accorded to contractual rights. A suggestion to that effect could be inferred by the bases of discussion submitted by the Preparatory Committee for the 1930 Hague Codification Conference. Thus, according to Basis of Discussion No.4:

"A state incurs responsibility if, by legislative act, it repudiates or purports to cancel debts for which it is liable.
A state incurs responsibility if, without repudiating a debt, it suspends or modifies the service, in whole or in part, by legislative act, unless it is driven to this course by financial necessity."

This basis of discussion was later rejected by the codification conference, however, as the majority of the participating countries were not willing to support it. A hesitation towards international responsibility for sovereign default was also shared by prominent writers of the era.[34] As Feilchenfeld eloquently put it some eighty years ago, international law will guarantee to the creditor the existence of a debt and of a debtor, but not the existence of a good debt and of a rich debtor.[35]

IIb. General principles of law are founded on analogical legal reasoning whereby lacunae in positive law are filled by a second rule that incorporates a general legal principle of broader application.[36] In the context of insolvency, there is a stark contrast between the highly regulated field of bankruptcy regarding private and municipal entities and that of sovereigns, which is based on voluntary workouts between the debtor country and its creditors. It appears, therefore, that bankruptcy law concepts originating from domestic jurisdictions can play an instrumental role in the development of international principles regarding sovereign insolvency. To the extent that bankruptcy law concepts have, by virtue of extensive consensus over their application,

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32 *ELSI Case* at para. 128, *L. F. H. Neer and Pauline Neer* U.S.A. v. United Mexican States (1926) IV 60-66 RIAA at 61-62.

33 Hollin Dickerson, *Minimum Standards*, Max Planck Encyclopedia of Public International Law (2010).

34 Borchard, *State Insolvency* at 118-120 ("A distinction has to be made as to the nature of the default. Only acts which purport to wipe out the obligation permanently and in its entirety, such as repudiation or cancellation, may be classified as confiscatory and contrary to international law"). Feilchenfeld argued that international law protects the "substance" of public debts, but not their "quality". Ernst H. Feilchenfeld PUBLIC DEBTS AND STATE SUCCESSION (1931) at 650-659 [hereinafter, Feilchenfeld *Public Debts*]

35 Feilchenfeld, *Public Debts* at 657.

36 Matthias Goldmann *Responsible Sovereign Lending and Borrowing: The View from Domestic Jurisdictions* A Comparative Survey Written for the United Nations Conference on Trade and Development at 11.

reached the status of a general principle of law proper, they will be applicable directly in the context of sovereign insolvency; where such *lex lata* status cannot be ascertained, domestic insolvency provisions can still play an important role in influencing existing international standards that are applicable in the field of public debt. This would be particularly pertinent where these standards are by their nature vague and underdeveloped, whereas their domestic insolvency counterparts have been refined by consistent jurisprudence.[37]

The following lines do not attempt to provide a comprehensive account regarding the application of domestic bankruptcy law principles to the field of sovereign insolvency,[38] but will rather focus on the particular issue of the establishment of enforceable priorities in sovereign debt on the basis of the application of general principles of insolvency law, in particular the maxim *pars conditio creditorum* (equal treatment of creditors). From the perspective of international responsibility, the existence of such priorities would entail the debtor state's responsibility if it were to deviate from the obligation to treat its creditors in accordance with their order in the priority ladder.

It is well established that a priority structure among creditors in sovereign insolvency already exists as a matter of practice.[39] What is more contested is what this *de facto* priority ladder means[40] and whether it should be followed as a matter of law. It should be moreover stressed that the establishment of legally enforceable priorities in sovereign debt would be a most welcome development from a policy perspective; to be sure, an extensive literature posits the lack of enforceable seniority structures as one of the core problems in sovereign debt

[37] The standard of "fair and equitable treatment" enshrined in most international investment agreements is by its nature broad and dynamic, whereas its application in the context of sovereign debt has not been adequately tested. On the other hand, according to US bankruptcy law regarding municipalities, the bankruptcy court can bind all the creditors of the debtor by accepting a reorganization plan agreed upon a prescribed majority of them (cramdown). However, dissenting creditors are protected by virtue of U.S. Code Title 11, Chapter 9, Section 1129(b)(1), pursuant to which "the court, on request of the proponent of the plan, shall confirm the plan... if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan". In contrast to the international investment law context, the notion of "fair and equitable" for domestic insolvency purposes has been substantiated by the case law of US bankruptcy courts, thereby offering important guidance for the development of the standard at the international plane. For a detailed discussion of the matter see Yanying Li *Policy Implication of Poštová Tribunal's Jurisdiction over Sovereign Bonds: Bankruptcy Cram-down and ICSID Arbitration available at* http://ssrn.com/abstract=2402643

[38] For a detailed account *see* Holger Schier TOWARDS A REORGANIZATION SYSTEM FOR SOVEREIGN DEBT *AN INTERNATIONAL LAW PERSPECTIVE* (Martinus Nihhoff, Leiden-Boston 2007) pp. 109-163.

[39] *See* Keith Clark *Sovereign Debt Restructurings: Parity of Treatment between Equivalent Creditors in Relation to Comparable Debts* 20 Int'l L. 857 1986 [hereinafter Clark *Sovereign Debt Restructurings*], Lee Bucheit *Of Creditors, Preferred or Otherwise* 10 Int'l Fin. L. Rev. 12 1991, Anna Gelpern, *Building a Better Sitting Chart for Sovereign Restructurings* 53 Emory Law Journal 1120 2006 [hereinafter Anna Gelpern *Building a Better Sitting Chart]*.

[40] Anna Gelpern, *Building a Better Sitting Chart* at 1130.

restructuring.[41] What is more, the fact that a seniority order already exists *de facto* offers the advantage of not disrupting existing market expectations but only reenforcing them by adding a layer of certainty through the acceptance of legal normativity.

In analyzing the maxim *pars conditio creditorum* and its relevance in the context of sovereign insolvency it should be first noticed that it constitutes a principle that is omnipresent in domestic insolvency statutes.[42] With regard to its content, it calls for substantive equality among creditors, that is equal treatment of equivalent creditors in relation to comparable debts[43] and differentiated treatment where those conditions are not present. As is the case in private insolvency, a sovereign debtor's creditors and obligations are extremely diverse ranging from debts owed to other sovereign states to credits advanced from suppliers of goods and services.[44] Still, these observations offer no insight in relation to the establishment of priorities, as they say nothing about which category of creditors will be granted seniority and which will be subordinated. Such a finding could be made only to the extent that a direct analogy could be drawn between domestic and sovereign insolvency in relation to a particular category of creditors that has the same characteristics in both contexts and is either senior or subordinated pursuant to the great bulk of domestic bankruptcy laws. This claim could be arguably made regarding at least three types of creditors that enjoy senior status -in the order they are juxtaposed below- in private insolvency and share the same characteristics in the sovereign context: creditors providing post insolvency financing, trade creditors and secured creditors.

Of those three creditor categories that is hereby argued that should be granted seniority by virtue of the extension of the *pars conditio creditorum* principle in the context of sovereign insolvency, trade creditors appear as the group that would face the least contestation. The seniority of secured creditors on the other hand seems to be of trivial value in the sovereign context, as secured sovereign debt is only marginal. The seniority of interim financing presents the problem that the analogy between the private and sovereign context is not perfect as in the latter case there is not a clearly identifiable moment when insolvency is initiated (for, there is no formal insolvency process for sovereigns). Be that as it may, it would not seem far-fetched to assume that the moment that the sovereign debtor approaches its (private or official) creditors in order to initiate restructuring negotiations is for all practical purposes the equivalent of an insolvency petition before the bankruptcy court. Hence, seniority could be granted to every private credit advanced from that point on.

It has been also proposed that a responsibility for granting abusive loans derived from domestic bankruptcy regimes should be recognized in the sovereign context, so as to subordinate

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[41] Patrick Bolton and David Skeel *Inside the Black Box: How Should a Sovereign Bankruptcy Framework be Structured?* 53 EMORY LAW JOURNAL 763 (2004), Patrick Bolton and Olivier Jeanne *Structuring and Restructuring Sovereign Debt: The Role of Seniority* NBER Papers 2005, Anna Gelpern *A Sceptic's Case for Sovereign Bankruptcy* 50 HOUS.L.REV 1095 (2013).

[42] Juan Pablo Bohoslavsky *Lending and Sovereign Insolvency: A Fair and Efficient Criterion to Distribute Losses among Creditors* 2 Goettingen J. Int'l L. 387 2010 [hereinafter Bohoslavsky *Lending and Sovereign Insolvency]* at 392-393.

[43] Clark *Sovereign Debt Restructurings* at 858.

[44] See pages 4,5 above.

creditors that advanced loans to a sovereign borrower faced with an unavoidable default.[45] Lending under such circumstances means that the debtor country is only pushed into deeper insolvency, whereas older creditors are also affected detrimentally as their claims are diluted by the new credits which are short-term and they usually enjoy higher rates and increased securities.[46] As invocation of this equitable subordination principle requires a demonstration that the creditor had the intention of damaging or obtaining an unfair advantage, Bohoslavsky has proposed that indirect evidence could be taken into account to reach that conclusion. Accordingly, harming intent and willingness to obtain unfair advantage could be proved by evidence such as the date on which the transaction was made, the execution date of the contract, the interest rate of the loan, the public availability of the information related to the debtor's situation, the human and material resources that the lender enjoyed in order to evaluate the risk, the economic volume of the loan, the legal nature of the contract, the request and constitution of strong collaterals and the acceleration of payments requested to the borrower.[47]

III. The theory of "quasi-international" contracts has been developed in the area of foreign direct investment (FDI) and suggests that contractual arrangements between states and foreign private law persons that have been concluded under municipal law are also directly governed by international law.[48] This internationalization of private law contracts arouse out of an increasing concern after the nationalization of the oil industry in the 1970's in the Middle East that states accepting investments within their territory would alter domestic laws to the detriment of foreign investors.[49]

Internationalization of FDI contracts was driven both by contractual practice and interstate agreements and in effect evidenced the desire of capital-exporting nations not only to insulate against unexpected changes of domestic legislation affecting investments, but also to contract out of international custom with a view to establish special and more protective international rules relating to FDI.

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[45] Bohoslavsky, *Lending and Sovereign Insolvency* supra note 42 at 398.

[46] *Id*

[47] *Id* at 400.

[48] Arguably, in contrast to the celebrated holding of the PCIJ according to which "Any contract which is not a contract between States in their capacity as subjects of international law is based on the municipal law of some country". *Case Concerning the Payment in Gold of the Serbian Federal Loans Issued in France* (France v. Serbia), Judgment No. 14, 1929 PCIJ Series A, 1-89, at 41.

[49] Irmgard Marboe and August Reinisch, *Contracts between States and Foreign Private Law Persons*, Max Planck Encyclopedia of Public International Law (2011).

As a matter of contract, internationalization takes place through arbitration clauses or provisions that refer to a different legal regime than solely that of the state party (common legal principles of the contracting state and the home state of the investor).[50]

At the interstate level, Article 42 of the ICSID Convention provides that tribunals formed under the auspices of the Centre will decide a dispute "in accordance with such rules of law as may be agreed by the parties. In the absence of such agreement, the Tribunal shall apply the law of the Contracting State party to the dispute and such rules of international law as may be applicable". What is more, bilateral investment agreements stipulate substantive standards of treatment for investments, including "umbrella clauses" that may elevate contractual default to an *ipso facto* violation of international law.

Hence, through this complex network of contractual and treaty provisions international standards become directly relevant to FDI contracts, notwithstanding their character as arrangements under private law.

However, contractual development in sovereign debt instruments has followed a different pattern compared to FDI.[51] Sovereign bonds uniformly contain choice of law and forum clauses that grant jurisdiction to the courts of a handful of advanced financial centers, whereas arbitration clauses are infrequent if not absent.[52] Reference to possibly vague international standards and multiple systems of law is rather undesirable for sovereign debt investors who prefer the certainty of particular systems of municipal law and the predictability of adjudication before domestic courts with experience in deciding financial disputes.[53] Sovereign borrowers also waive immunity from jurisdiction and execution thereby positing themselves on an equal footing with common commercial contractors. These special characteristics of sovereign debt arguably make the internationalization of debt contracts much more contested compared to traditional FDI.[54] The following lines will address whether sovereign insolvency could trigger state responsibility according to the substantive standards of Bilateral Investment Treaties (BITs), thereby effectively internationalizing sovereign debt contracts.

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[50] *Id.*

[51] According to Delaume, "There is, therefore, a remarkable contrast between the practice of lenders and that which is said to obtain in respect to other transactions, especially concessions and similar agreements, between private and international persons. While in the latter case, an attempt has sometimes been made to remove the relationship from domestic law by making it subject to international law, the general principles of law, or some "quasi-international" system of law the existence of which is far from established, no evidence of any similar trend is noticeable in the majority of contemporary loan agreements". George R. Delaume *The Proper Law of Loans Concluded by International Persons: A Restatement and a Forecast* 56 Am. J. Int'l L. 63 1962 at 25-26.

[52] Brazilian bonds are documented as a notable exemption as they commonly contain UNCITRAL arbitration clauses.

[53] Mann's insight according to which the application of international law to sovereign debt contracts is conditional on the absence or invalidity of a choice of domestic law by the parties probably echoes this attitude of creditors. F.A. Mann, *The Law Governing State Contracts* 21 Brit. Y.B. Int'l L. 11 1944 at 21.

[54] Especially concerns relating with respect to party autonomy familiar to the internationalization of FDI contracts are much more exacerbated in the context of sovereign debt.

The discussion of whether sovereign debt instruments, and sovereign bonds in particular, are protected by the substantive standards of treatment of BITs has been intense during the last years, with most commentators agreeing that BIT protection of sovereign bonds is at least possible.[55] More recently, two ICSID tribunals moved the debate from the academic sphere to reality by accepting jurisdiction over bond claims of Italian creditors, following Argentina's 2001 default, on the basis of the Italian-Argentine BIT.[56] Although these cases are the first involving exclusively sovereign bonds, the two rulings are consistent with previous ICSID case law regarding the qualification of financial instruments as protected investments under the ICSID Convention.[57]

Since a detailed treatment of the issue is outside the scope of the present study, the following lines will attempt to shed light in a telegraphic manner to the most contested jurisdictional and substantive issues regarding BIT arbitration over sovereign bonds.

As mentioned above, sovereign bonds uniformly contain choice of law and forum clauses granting jurisdiction to the courts of a small number of financial centers, with arbitration clauses being virtually absent. Thus, the necessary consent to international arbitration of the debtor state is not part of the contractual agreement with its creditor, but is provided by virtue of an arbitration clause contained in a BIT that has concluded with the creditor's home state. On the other hand, the filling of a claim before the ICSID secretariat by the creditor evidences its consent to submit the particular dispute to arbitration.

Undoubtedly, the most contested issue regarding the jurisdiction (*ratione materiae*) of ICSID tribunals over sovereign bonds is their qualification as protected investments under the ICSID Convention.[58] To be sure, the debate in the context of sovereign bonds reflects the broader problematic of what constitutes an "investment" under Article 25 of the ICSID

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[55] *See* Karen Halverson Cross *Arbitration as a Means of Resolving Sovereign Debt Disputes* The American Review of International Arbitration 2006/Vo.17 No.3, Alexander Szodruch *State Insolvency-Consequences and Obligations Under Investment Treaties* in The International Convention on the Settlement of Investment Disputes (ICSID) Taking Stock After 40 Years Rainer Hofmann and Christian Tams (eds.), Thomas W.Walde, The *Serbian Loans* Case: A Precedent for Investment Treaty Protection of Foreign Debt? in International Investment Law and Arbitration Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law (2005). *Contra* Michael Waibel, *Opening Pandora's Box: Sovereign Bonds in International Arbitration* Am.Journal of International Law 711-759 [hereinafter, Waibel *Opening Pandora's Box*] (2007).

[56] *Abaclat and Others v. Argentine Republic*, ICSID Case No. ARB/07/5 (formerly *Giovanna a Beccara and Others v. The Argentine Republic*) Decision on Jurisdiction and Admissibility [hereinafter *Abaclat*], *Ambiente Ufficio S.p.A. and others v. Argentine Republic*, ICSID Case No. ARB/08/9 (formerly *Giordano Alpi and others v. Argentine Republic*) Decision on Jurisdiction and Admissibility [hereinafter *Ambiente*].

[57] *Fedax N.V. v. The Republic of Venezuela*, ICSID Case No. ARB/96/3, *Ceskoslovenska Obchodni Banka, A.S. v. The Slovak Republic*, ICSID Case No. ARB/97/4.

[58] Of course, this inquiry does not apply to arbitration proceedings under other rules, such as the UNCITRAL rules or the rules of the Stockholm Chamber of Commerce for instance.

Convention and the methods to be used to ascertain it.[59] Thus, one's disposition on the one or the other side of this debate will likely lead to an affirmative or negative answer to the question of whether ICSID tribunals can assume jurisdiction over sovereign bonds.

The tribunals in *Abaclat* and *Ambiente* are in line with an application of the so called "double-barreled" test that prioritizes the parties' consent to arbitration, whereby the definition of "investment" is primarily a task to be regulated by the relevant BIT. According to this perspective, Article 25 of the ICSID Convention functions as a loose check on the parties' definition of investment that would bar jurisdiction in cases of profound misalignment of their will with the general understanding of investment, such as in cases of common commercial transactions.[60] Therefore, in light of the broad definition of investment of the Argentina-Italy BIT,[61] the two tribunals assumed jurisdiction over the claims of the Italian bondholders.

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[59] Whereas it appears that case law and theory have settled towards the adoption of a "double-barreled" test according to which a protected investment should fit into the definition of the relevant BIT and be consistent with the inherent meaning of investment pursuant to Article 25 of the ICSID Convention, ICSID tribunals have adopted two different approaches to the test. A number of tribunals, led by *Salini v Morocco* (*Salini Costruttori S.p.A. and Italstrade S.p.A. v. Kingdom of Morocco*, ICSID Case No. ARB/00/4 Decision on Jurisdiction at pp.622-623), emphasize that investment has an autonomous meaning that poses strict constrains to the parties' definition of the term. Thus, in order to satisfy the requirements of article 25 of the ICSID Convention, protected investments should display five typical characteristics, as cumulatively mandatory requirements: a) substantial commitment of capital b) certain duration c) assumption of non commercial risk d) significance for the host state's development e) regularity of profit and return.
On the other hand, tribunals such as *Biwater Gauff v Tanzania* (*Biwater Gauf v. Tanzania*, ICSID Case No. ARB/05/22 at para.312), and the annulment committee in *Malaysian Historical Salvors v Malaysia* (*Malaysian Historical Salvors, SDN, BHD v. The Government of Malaysia*, ICSID Case No. ARB/05/10 Decision on the Application for Annulment at paras.75-79) rejected the *Salini* approach and the rigid application of any criteria in order to determine covered investments according to article 25. This line of reasoning interprets the Convention's silence on the definition of investment as an implicit deference to the parties' will on the matter. Accordingly, article 25 would preclude jurisdiction only where the parties' definition is manifestly inconsistent with the general notion of investment.

[60] Rudolf Dolzer and Christoph Schreuer, PRINCIPLES OF INTERNATIONAL INVESTMENT LAW, Oxford University Press (2012) at 76 [hereinafter Dolzer and Schreuer *Principles of International Investment Law*].

[61] According to Article 1(1) of the 1990 Argentina-Italy BIT:
"Investment" shall mean, in compliance with the legislation of the receiving State and independent of the legal form adopted or of any other legislation of reference, any conferment or asset invested or reinvested by an individual or corporation of one Contracting Party in the territory of the other Contracting Party, in compliance with the laws and regulations of the latter party.
In particular, investment includes, without limitation:
(a) movable and immovable property and any other property rights such as collateral securities over the property of third parties to the extent they may be used for investment;
(b) shares, quotas and other holdings, including minority or indirect holdings, in companies incorporated in the territory of one of the Contracting Parties;
(c) bonds, private or public financial instruments or any other right to performances or services having economic value, including capitalized revenues;
(d) credits which are directly related to an investment, lawfully created and documented pursuant to the legislation in force in the State where the investment is made;
(e) copyrights, intellectual or industrial property rights such as patents, licenses, registered trademarks, secrets, industrial models and designs as well as technical
(f) processes, transferrals of technological know-how, registered business names and goodwill;
(g) any right of economic nature conferred under any law or agreement, as well as any license and concession granted in compliance with the applicable provisions governing the performance of the related economic activities, including prospecting, cultivating, extracting and exploiting of natural resources

In *Abaclat* the tribunal expressly rejected the *Salini* criteria[62] as mandatory requirements for the identification of protected investments under article 25 and it focused on whether the "contributions" made by the Italian creditors were capable of creating the "value" that Argentina and Italy sought to protect via their BIT.[63] That being so, the tribunal was satisfied that the "contribution" of Italian bondholders qualified as a protected investment under article 25.[64]

In *Ambiente* the question of *ratione materiae* jurisdiction of ICSID tribunals over sovereign bonds was addressed in a clear and detailed manner in light of the interpretative rules of the Vienna Convention on the Law of Treaties (VCLT). The tribunal concluded that "[t]he term "investment" in Art. 25 of the ICSID Convention, when interpreted in accordance with its ordinary meaning, in its context and in light of the object and purpose of the Convention, is to be given a broad meaning, i.e. with jurisdictional limits arising from this provision only at the outer margins of economic activity". [65] Even if the meaning of "investment" was to be considered as "ambiguous or obscure" pursuant to article 32 of the VCLT, reference to the *travaux preparatoires* of the ICSID Convention supports the qualification of financial instruments, such as sovereign bonds, as protected investments under article 25 of the ICSID Convention.[66]

Although an approach to the "double barreled" test that construes article 25 of the ICSID Convention broadly appears to be strongly founded in both doctrine and jurisprudence, an application of the *Salini* criteria or of some variant formulation[67] is in no way out of the question[68]. In this case a tribunal could well decline to accept jurisdiction over sovereign bonds due to failure to satisfy some of the typical characteristics of investments.[69] A negation of jurisdiction would be all the more likely if the adoption of jurisdictional requirements on the basis of the typical characteristics of an investment is accompanied by an understanding of sovereign lending that separates the issuance of bonds from the purchase of security entitlements

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[62] *Abaclat* para.364.

[63] *Id* at para.365.

[64] *Id* at paras. 366-367.

[65] *Ambiente* para.470.

[66] *Id* at para 474.

[67] See for instance, Waibel, *Opening Pandora's Box* at 723.

[68] ICSID awards and decisions have not the value of precedent and tribunals commonly adopt reasonings that are in sharp contrast with previous rulings.

[69] It should be noted that in *Ambiente* the tribunal concluded that even the application of the *Salini* criteria would not bar jurisdiction over sovereign bonds. Paras. 482-487.

in the secondary market.[70] According to this approach, each purchase of a security entitlement in the secondary market should independently qualify as an investment and meet the relevant criteria thereof, thereby posing a significant barrier to the Center's jurisdiction over sovereign bonds.

A central issue with regard to international responsibility for sovereign insolvency on the basis of BITs' standards of treatment is the effect of the operation of Collective Action Clauses (CACs)[71] on the jurisdiction of tribunals to rule on bondholders' claims. In more detail, the inquiry here is whether bondholders that were outvoted in a CAC vote and thus had their claims restructured can nevertheless invoke the protections of a BIT. The importance of this question cannot be overstated given the high proliferation of CACs as the central mechanism for dealing with collective action problems.

In that vein, allowing bondholders' claims to be heard by treaty-based tribunals despite the successful operation of CACs may run contrary to the governmental-commercial act distinction dogma of investment treaty arbitration. Consistently with the public law nature of international investment law and absent a provision to the contrary, ICSID tribunals only have jurisdiction over states' acts that are of a sovereign character. *Prima facie,* restructurings brought about through the operation of CACs do not involve the exercise of governmental authority by the debtor state, as CACs are a fundamentally market driven mechanism. Accordingly, it has been argued that the government's restructuring proposal is only the proximate cause of bondholders' losses.[72] This view, however, can be criticized for unduly severing the restructuring process that might be implemented through market friendly means but the determination of its most essential elements remains the debtor country's prerogative. Most importantly, the percentage of the "haircut" that bears directly upon bondholders' losses is regularly determined by the state after having consulted with the IMF regarding debt sustainability and is merely confirmed through a CAC vote. Besides, the decision to restructure itself is an inherently sovereign droit, in the lack of which there is no scope for the activation of CACs.

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[70] Sovereign borrowers typically issue dematerialized global bonds to a single financial intermediary (underwriter) and subsequent investors purchase security interests to the initial bond issue in the secondary market. In these transactions the sovereign borrower only receives a lump sum payment from the underwriter, who subsequently sells security entitlements to the end investors. The question then arises which economic understanding of the process of sovereign funding would be adopted by tribunals. One approach -the one adopted by the tribunals in *Abaclat* and *Ambiente*- is to consider the transactions of the bond issuance and the purchase of security interests as inseparable parts of a complex but single economic operation that should meet the requirements of investment as a whole. Another approach would be to distinguish the bond issuance and the purchase of security interests and consider them as separate and independent transactions, thereby making it necessary for the securities purchases to be apt to stand alone as investments. The latter approach could also pose obstacles to ICSID jurisdiction *ratione loci* with regard to article's 25 requirement that investments should be made "in the territory" of the host state.

[71] In a typical collective action clause, a supermajority vote by creditors could alter the payment terms of a particular bond issuance, thereby binding the totality of creditors holding bonds of the same series to the amended terms.

[72] Waibel, *Opening Pandora's Box* at 737.

After having assumed jurisdiction over a claim based on sovereign bonds, an ICSID tribunal would move to assess whether the treatment of the debtor state to its creditors violated one or more of the substantive disciplines of the relative BIT. Under these disciplines, host states guarantee to foreign investors certain standards of treatment (most notably, not to expropriate without compensation, fair and equitable treatment, most favored nation and national treatment and commitment to honor the agreements entered with investors), the violation of which would entail the state's international responsibility. A relatively novel practice in investment treaties is the inclusion of sovereign debt restructuring annexes that limit the host state's liability with regard to sovereign debt to national and most favored nation (MFN) treatment.[73]

The concept of expropriation under international investment law covers both open or outright expropriation in the sense of formal loss of legal title over the investment and indirect or *de facto* expropriation where the inquiry focuses on a finding of substantial deprivation of the investment's value. In the context of a sovereign default or debt restructuring, both types of expropriation are possible. On the one hand, the imposition of prolonged debt moratoria without any prospect of recovery could have the effect of nullifying the economic benefit to which bondholders aspired, thereby amounting to an indirect expropriation. On the other, formal loss of legal title over the debt instruments might come as the result of legislative or administrative measures that debtor states undertake during a debt restructuring. Under both scenarios, however -and this requirement will be more contested in cases of indirect expropriation where no formal loss of legal title will have taken place- it will be necessary to demonstrate that creditors' losses were the result of the exercise of governmental authority by the debtor state.[74]

Indeed, the tribunals in *Abaclat* and *Ambiente* required the existence of an act of public authority on the part of the debtor state in order to qualify a claim as treaty based and argued that

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[73] Annex 10-B of the Chile-U.S. Free Trade Agreement, June 6, 2003, limits obligations relative to public debt to national and MFN treatment: "The rescheduling of the debts of Chile . . . owed to the United States and the rescheduling of its debts owed to creditors in general are [subject only to] article 10.2 [MFN treatment] and 10.3 [national treatment]." See U.S.-Australia Free Trade Agreement, May 18, 2004, Art. 11.17(4)(c); U.S.-Morocco Free Trade Agreement, June 14, 2004, Art. 10.27(c); U.S.–Central America–Dominican Republic Free Trade Agreement, Aug. 2, 2005, Art. 10.28(c). Similar policy considerations are apparent in the U.S.-Uruguay BIT, Nov. 4, 2005. Its Annex G qualifies treatment standards with respect to sovereign debt: "No claim that a restructuring of a debt instrument issued by Uruguay breaches an obligation under Articles 5 through 10 [fair and equitable treatment, full protection and security, expropriation] may be submitted to . . . arbitration . . . if the restructuring is a negotiated restructuring . . . ." U.S. free trade agreements and bilateral investment treaties are available at the Office of the U.S. Trade Representative Web site, http://www.ustr.gov. Cited *in verbatim* from Waibel, *Opening Pandora's Box* at 729.

[74] It is generally accepted that expropriation of contractual rights is possible only when interference with them is effectuated through the governmental actions of the state. *Waste Management Inc v. United Mexican States,* Award, ICSID Case No. ARB(AF)/00/3, April 30 2004 paras 159-60, *Biwater Gauff (Tanzania) Ltd. v. United Republic of Tanzania*, ICSID Case No. ARB/05/22 paras 491-493.

mere non payment of debts could not trigger liability under the Argentina-Italy BIT.[75] Argentina's enactment of the so called "Lock Law" qualified as a sovereign act and enabled the tribunals to accept jurisdiction over the claims of Italian investors.[76] Once the tribunals decide the case on the merits, the "Lock Law" could be found violative of the provision in Argentina-Italy that prohibits expropriation without adequate compensation.

The recent Greek sovereign debt restructuring required the retrofit insertion of a collective action clause through legislation so as to induce/compel the holders of Greek law bonds to tender their instruments.[77] Pursuant to article 1 paragraph 9 of the Law, "In case of exchange of eligible securities, upon the registration in the system of the new securities, all eligible securities that are exchanged for new securities are thereby cancelled, and any rights or obligations arising from them, including any and all rights and obligations that at any time were part of these, are extinguished." The law also made the exchange mandatory to those bondholders that refused to tender their bonds, as "the decision of the Bondholders (that accepted the tender), is valid against all bondholders and investors of eligible securities and supersedes any general or special law or act or agreement." Thus, the Greek Bond Modification law might be found expropriatory to the extent that it essentially cancelled the contractual rights of the bondholders that did not exchange their bonds and therefore it went far beyond mere contractual breach.[78]

In case that an expropriation claim cannot be substantiated, bondholders can still argue that their investments were not accorded fair and equitable treatment (FET). The concept of fair and equitable treatment is a dynamic standard founded on the general principle of good faith. As such, it protects the legitimate expectations of investors, as these can be ascertained through the host state's legal framework and its implicit or explicit undertakings and representations. Also, state regulation affecting investments must be reasonable *vis a vis* the objective pursued.

In the context of portfolio investment in sovereign bonds, the possibility of default or restructuring is generally reflected in the interest rate of each instrument; accordingly, creditors holding instruments that bear higher interest rates are well aware that the extra returns they

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[75] *Abaclat* paras 321-325, *Ambiente* paras 543-549.

[76] On February 10, 2005 Argentina passed Law 26,017 pursuant to which "[T]he national State shall be prohibited from conducting any type of in-court, out-of-court or private settlement with respect to bonds that were eligible to participate in the 2005 exchange offer". In order to reopen the restructuring process, on December 9, 2009, Argentina enacted Law 26,547 that suspended Law 26,017 until the completion of the 2010 exchange offer, providing that "[A]rgentina...is prohibited to offer holders of government bonds who may have initiated judicial, administrative, arbitration or any other type of action, more favorable treatment than what is offered to those who have not done so"

[77] Law 4050/2012, entitled "Rules on modification of securities, issued or guaranteed by the Greek state with an agreement of the Bond holders" (The Bond Modification Law).

[78] However, this will not be the case if the the Bond Modification law is deemed to be a reasonable regulatory measure in order to effectuate the restructuring of the country's debt. A detailed analysis of this issue follows below (pp.23-24) in the context of the FET standard. If the Bond Modification law is found to be reasonable for the purposes of the FET standard, the same result would apply *a fortiori* in the context of the expropriation analysis.

receive imply a higher possibility of non payment. Consequently, it would be very difficult for emerging market or distressed debt investors to argue that default frustrated their legitimate expectations.

The situation could be different, however, with regard to investments made in presumably risk-free debt of more developed issuers, such as Eurozone member-states,[79] before the emergence of the region's crisis. Throughout the unfolding of the Eurozone sovereign debt crisis and up until March 2012 when the Greek debt was finally restructured, European officials made strong statements about the impossibility of debt forgiveness within the Eurozone in an attempt to calm investors who at that time were abandoning *en masse* Greek, Portuguese, Irish, Spanish and Italian debt. To what extent those statements created legitimate expectations of full repayment to investors that suffered losses from the Greek restructuring is a question with no clear-cut answer that needs to be addressed in light of the circumstances of each particular claim. It could be argued, nevertheless, that a sophisticated investor ought to be aware of the provisions in the Treaty of the Function of the European Union (TFEU) which hold each member state responsible for the repayment of its debts,[80] thereby essentially allowing the possibility of sovereign defaults or restructurings within the EU and the Eurozone.[81]

Moreover, a tribunal will need to take into account the fact that sovereign bonds that are subject to the issuing country's domestic law yield higher rates than bonds under foreign law.[82] This spread reflects the capacity of the debtor country to unilaterally alter its payment obligations with regard to its domestic law bonds, something that is not possible for foreign law instruments. Under standard market understanding, an investor that purchases a sovereign's domestic law bonds essentially assumes the risk of modification of the bonds' terms through legislative fiat in

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[79] Of course, the presumption of risk-free debt could be indeed valid for countries like Germany or Finland but not so for others, like Greece, which since its independence in the 1820s until well after World War II was virtually in a situation of permanent default. See Carmen Reinhart & Kenneth Rogoff THIS TIME IS DIFFERENT-EIGHT CENTURIES OF FINANCIAL FOLLY Princeton University Press (2010) [hereinafter Reinhart & Rogoff *This Time is Different*] at 98.

[80] Article 123(1)TFEU provides (prohibition of monetary funding):
"Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as 'national central banks') in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments."
Article 125 of the TFEU (no bail-out clause) adds that:
"The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project."

[81] Tolek Petch, Kathrine Meloni LEGAL ASPECTS OF THE EUROZONE CRISIS Slaughter and May (July 2012) [hereinafter Petch and Meloni *Legal Aspects of the Eurozone Crisis*] at 313.

[82] *See* Eric Posner et al *Pricing Terms in Sovereign Debt Contracts: A Greek Case Study with Implications for the European Crisis Resolution Mechansim* The University of Chicago Law School Research Papers available at http://www.law.uchicago.edu/faculty/research/eric-posner-pricing-terms-sovereign-debt-contracts-greek-case-study-implications-eu

exchange for higher returns. Accordingly, it could be fairly said that not only there are no legitimate expectations of investors regarding the stability of the legal framework regarding sovereign bonds, but in fact quite the contrary applies, that is, the clear acknowledgement on their part of the intrinsic uncertainty that characterizes the legal protections of sovereign bonds issued under domestic law.

Discriminatory treatment could be another ground for triggering responsibility on the basis of the FET standard.[83] Considerations of expedience usually drive debtor countries to differentiate among their creditors in crafting the terms of a restructuring. Creditors that represent a small fraction of the debtor country's overall obligations may escape the restructuring altogether, especially if they hold instruments that are more difficult to restructure. Indeed, that was the case in the Greek restructuring where claims of €6.5 billion that were governed by English law (accounting for 30 per cent of the total value of foreign law debt) were not restructured as holdouts obtained blocking positions and prevented the operation of CACs.[84] It appears possible therefore for those creditors that held Greek law bonds and were restructured pursuant to the Bond Modification law to claim that they were discriminated *vis a vis* holders of foreign law bonds. It is submitted, however, that such an argument should be approached with caution. According to the tribunal in *Saluka Investments BV v. Czech Republic,*[85] discriminatory treatment in the context of the FET standard requires a finding of similar cases that have been treated differently without reasonable justification.[86] In essence, this means that the principle of non-discrimination does not inhibit any differentiated treatment, but only such differentiations that lack a reasonable basis.[87] In the case of the Greek restructuring, as the non-restructured bonds were under foreign law, the Greek legislation could not have any effect upon them and thus there was no possible way to restructure those instruments apart from the operation of CACs. The Greek authorities indeed set forth a restructuring proposal to the holders of foreign law bonds that was however rejected by them pursuant to the prescribed contractual mechanism of collective voting. Accordingly, the preferential treatment that foreign law creditors enjoyed was not only reasonable, but in fact inevitable.

The only case decided on the merits so far where sovereign bonds were at stake is *Continental Casualty v. Argentina.*[88] In this case the tribunal held that the restructuring of certain Treasury Bills (LETEs) by the Argentine Republic violated the FET standard of the US-Argentina BIT. The tribunal noted that its finding was based on the requirement that holders of

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[83] *Parkerings-Compagniet AS v. Lithuania*, ICSID Case No. ARB/05/8 (2007) at para 280, *Victor Pey Casado and President Allende Foundation v. Chile*, ICSID Case No. ARB/98/2 (2008) at paras 671-674

[84] IMF Working Paper *Sovereign Debt Restructuring-Recent Developments and Implications for the Fund's Legal and Policy Framework* April 26, 2013 at 28.

[85] *Saluka Investments BV v. Czech Republic* UNCITRAL (2006)

[86] *Id* at para 313.

[87] Roland Klager FAIR AND EQUITABLE TREATMENT IN INTERNATIONAL INVESTMENT LAW Cambridge University Press 2011 at 189.

[88] *Continental Casualty Company v. The Argentine Republic*, ICSID Case No. ARB/03/9

LETEs had to waive the legal protections accorded to these instruments (including recourse to arbitration) in order to participate in the swap.[89] The Greek Bond Modification law contains a provision to same effect[90] that could be construed as tantamount to denial of justice suffered by the bondholders, as pursuant to this stipulation they were deprived of their contractual causes of action according to the original bonds. It should be stressed, however, that the notion of reasonableness is central to the concept of the FET standard. In a sovereign debt restructuring, the implementation of legislation modifying the contractual rights of bondholders by the debtor country is often essential in achieving the desired level of creditor participation and returning to solvency. Seen from this prism, even far-reaching intrusion with creditors' rights could qualify as reasonable for the purposes of the FET standard. In the case of Greece, creditor participation before the implementation of the Bond Modification Law reached a mere 83.5%, a particularly low rate that could not bring about the desired level of debt relief that the country needed.[91] After the enactment of Law 4050/2012, the participation rate elevated at 97%,[92] a percentage that Greece's official creditors deemed sufficient to restore the country's solvency.

What could be problematic with the Greek restructuring, however, is not the cancellation of the bondholders' rights pursuant to the exchanged bonds *per se,* as this is a standard feature of restructuring techniques, but rather the means that law 4050/2012 prescribed to bring about the bond exchange. Although law 4050/2012 was coined as a CAC, this in fact is more an euphemism than reality as the law has little to do with standard CACs or even enhanced CACs that allow for cross-series aggregation of votes. Traditional CACs enable a qualified majority of bondholders (typically 75 percent of the outstanding principal) to bind all bondholders within the same bond issue to the financial terms of a restructuring.[93] Crucially, these CACs limit bondholder voting on the same series of bonds and thus it is relative easy for a creditor that wishes to hold out to acquire a blocking position and prevent the restructuring of a particular series of bonds. In order to smooth restructurings, aggregation CACs were later introduced. These enhanced clauses make it possible to amend the financial terms of bonds on the basis of aggregate voting across affected bonds in cases where the amendment affects two or more series of bonds.[94] Thus far, only four countries have included aggregation clauses in their sovereign

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[89] *Id* para. 264.

[90] Pursuant to article 1, paragraph 9 of law 4050/2012, "In case of exchange of eligible securities...eligible securities exchanged for new securities are cancelled, along with any rights and obligations thereunder, including any and all rights and obligations that at any time formed part of these".

[91] Allen & Overy Global Law Intelligence Unit *How the Greek Debt Reorganization of 2012 Changed the Rules of Sovereign Insolvency* at 4.

[92] *Id.*

[93] IMF Policy Paper, April 2013, SOVEREIGN DEBT RESTRUCTURING—RECENT DEVELOPMENTS AND IMPLICATIONS FOR THE FUND'S LEGAL AND POLICY FRAMEWORK at 29

[94] *Id*

bonds: Argentina, the Dominican Republic, Greece,[95] and Uruguay (The ESM Treaty requires the inclusion of standardized aggregation clauses in all new euro area government bonds with a maturity above one year starting from January 1, 2013).[96] Specifically, if the sovereign chooses to amend the bonds on an aggregated basis, two voting thresholds must be met: (i) 75 (Greece) or 85 (Argentina, Uruguay and the Dominican Republic) percent of the aggregated outstanding principal of all series to be affected and (ii) 66 percent of the outstanding principal of each individual series to be affected.[97] The latter voting threshold is lower than the typical 75 percent majority needed under CACs.[98] Law 4050/2012, however, completely dispensed with series by series voting and prescribed voting thresholds far below market negotiated CACs, thereby making holding out effectively impossible.[99] This element of the Greek restructuring has the potential to trigger responsibility on the basis of the FET standard if it is perceived as a deprivation of creditors' right to a fair process that ensures adequate representation of their interests.

MFN and national treatment clauses protect investors against discrimination on the basis of nationality. In the sovereign debt context, differentiated treatment among bondholders is a common concern and sovereigns with limited funds often struck sweetheart deals with domestic lenders to the detriment of foreigners.[100] Moreover, as the eurozone sovereign debt crisis demonstrated, official authorities, such as the European Central Bank or the European Investment Bank, may be insulated from losses on their holdings of a sovereign's debt.[101]

In dealing with cases of discrimination on the basis of nationality, it seems that there is significant ground to argue that domestic and foreign creditors are hardly in comparable circumstances in the context of the debtor country's economy. Domestic banks and pension funds play a crucial role in the smooth function of national economies, and societies at large, thereby rendering their preferential treatment an overriding imperative. Official authorities like the ECB that purchased Greek bonds as part of its Securities Market Program (SMP) in order to support the secondary market for Greek debt and not as an investment instrument are clearly at a

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95 Aggregation CACs have been included in the country's new bonds that were issued pursuant to the March 2012 restructuring.

96 *Supra note 92*

97 *Id*

98 *Id*

99 Anna Gelpern *Contract Hope and Sovereign Redemption* 8 Cap. Markets L.J. 132-148 (2013) at 144-145.

100 The Argentine (2001) and Russian (1998) defaults are prominent examples of unequal treatment between national and foreign creditors. For a detailed analysis see, Anna Gelpern and Brad Setser *Domestic and External Debt: The Doomed Quest for Equal Treatment* Georgetown Journal of International Law (2004).

101 The bonds of the Greek state held by the European Central Bank, the European Investments Bank and the central banks of Eurozone member-states as a result of open market purchases, were exempted from the PSI. In fact, the ECB and the EIB exchanged their bonds with identical new issuances (same maturity, interest rates etc.) before the exchange of the bonds of private creditors. *See* Alexander Metallinos *The Greek Sovereign Debt Restructuring* in Sovereign Debt and Debt Restructuring: Legal, Financial and Regulatory Aspects (2013) at 25.

different footing with other market participants and on the basis of this criterion a discrimination claim on the basis of an MFN clause is likely to fail.

Umbrella or *pacta sunt servanda* clauses contain the commitment of the host state that the agreements entered into with foreign investors will be honored. The interpretation of these clauses has caused heated debates, a comprehensive analysis of which is certainly outside the scope of this chapter. Under a line of ICSID awards umbrella clauses elevate contractual default to an *ipso facto* violation of the relevant BIT,[102] something that would have the effect of rendering a single loss of an interest payment on a bond to an internationally wrongful act. On the other hand, a number of tribunals have concluded that exclusively contractual breaches are not transformed to treaty breaches by virtue of observance of obligations clauses, except where an express intention to that effect could be found in the clause.[103] A middle solution supports a distinction between sovereign and commercial acts and requires the exercise of sovereign authority as a condition for the violation of umbrella clauses.[104]

Evidently, the position of a tribunal on the interpretation of a particular umbrella clause could be crucial in deciding weather a default or restructuring violated it. As noted above, sovereign bonds uniformly contain exclusive jurisdiction clauses that according to a school of thought either constitute an implicit waiver of the investor's right to bring the claim before a treaty-based tribunal[105] or could have the effect of rendering a claim based on an umbrella clause inadmissible.[106] Waibel has argued that allowing a predominantly contractual claim to give rise to responsibility on the basis of a BIT when the investment contract contains an exclusive jurisdiction clause would unravel the contract's unity, as the claimant would rely on one contract provision to substantiate its claim, while at the same time would deny another regarding the exclusive jurisdiction of domestic courts.[107] To the present author's view, however, it seems righter to accept that contractual exclusive jurisdiction clauses and "umbrella clauses" function

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[102] *Noble Ventures, Inc. v. Romania*, ICSID Case No. ARB/01/11 at paras 46-62, *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, ICSID Case No. ARB/02/6 at para. 127, *Eureko B.V. v. Republic of Poland* at para. 250, *SGS Société Générale de Surveillance S.A. v. The Republic of Paraguay,* ICSID Case No. ARB/07/29 at para. 90.

[103] *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, ICSID Case No. ARB/01/13 at paras. 166,167, *Joy Mining Machinery Limited v. Arab Republic of Egypt*, ICSID Case No. ARB/03/11 at para. 81.

[104] *CMS Gas Transmission Company v. The Republic of Argentina* ICSID Case No. ARB/01/8 [hereinafter *CMS v. Argentina*] at para. 299 , *Sempra Energy International v Argentine Republic,* ICSID Case No. ARB/02/16 (Annulled on other grounds) at para. 310 [hereinafter, *Sempra v. Argentina*].

[105] For a detailed account see Jan Ole Voss THE IMPACT OF INVESTMENT TREATIES ON CONTRACTS BETWEEN HOST STATES AND FOREIGN INVESTORS Martinus Nijhoff Publishers Leiden-Boston 2011 at 320 [hereinafter, Ole Voss *The Impact of Investment Treaties on Contracts*]

[106] *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, ICSID Case No. ARB/02/6, according to which the determination of a violation of a contract is subject to a judgment of domestic courts, at para 154.

[107] Michael Waibel, SOVEREIGN DEFAULTS BEFORE INTERNATIONAL COURTS AND TRIBUNALS Cambridge University Press (2011) p.262 [hereinafter, Waibel *Sovereign Defaults*].

in parallel, thus allowing treaty-based tribunals to rule upon claims that are of fundamentally contractual character but are also covered by the BIT. This is consistent with the view that one of the innovative contributions of the BIT regime is to offer further dispute settlement fora to the investor.[108]

Turning back to the Greek Bond Modification Law, to the extent that the law is found violative of the terms of the tendered Greek law bonds,[109] it could trigger umbrella clauses in Greece's BITs with the home countries of its bondholders. This question, however, would be judged on the basis of the *lex contractus*, that is Greek law, and the consistency of the Bond Modification Law with provisions of the Hellenic Constitution and the ECHR protecting the right to property (Article 17 HC, Article 1 of the first additional protocol to the ECHR) and in light of the principle of equality (Article 4 para.1 HC, Article 14 ECHR). Paradoxically, under this scenario the adoption of legislative measures directly interfering with creditors' rights could absolve the debtor state from responsibility -if they were to be found consistent with constitutional and other supranational provisions- on the basis of "umbrella clauses", whereas a presumably less intrusive default would most certainly amount to a breach of contract under domestic law, thereby triggering responsibility for violating the "umbrella clause".

The examples of the Argentine default and the Greek PSI that were used in the previous lines as case studies demonstrate that when it comes to sovereign insolvency states can use drastically different ways to deal with their creditors. On the one hand, Argentina defaulted on approximately $100 billion of external debt before approaching its creditors to find a commonly agreed compromise; on the other, the voluntariness of the Greek debt restructuring was a priority for the EU and Greece, and thus the country avoided events of default under its bonds. Even so, both countries had to pass legislative measures with far-reaching effects on bondholders' rights in order to achieve sufficient debt reduction. This stresses the fact that, irrespective of a creditor-friendly or hostile attitude on the part of the debtor state, the underlying policy imperative will always be the restoration of solvency.

The above analysis ultimately concludes that the prescribed BIT standards of treatment -especially those concerning FET or even expropriation- have the potential to significantly upset sovereign debt restructurings. This is all the more likely when sovereign debtors implement legislative or administrative measures in order to cajole or in fact compel their creditors to participate in the restructuring. As the two biggest sovereign debt restructurings in economic history demonstrate, market negotiated practices are not a perfect substitute for the exercise of governmental authority and thus the *acta jure imperii-jure gestionis* distinction maxim of international investment arbitration may be of limited significance for troubled sovereigns.

What can be fairly said at that stage is that the decisions on jurisdiction in *Abaclat* and *Ambiente* have signaled a trend towards the internationalization of disputes arising out of sovereign debt, something that is unprecedented since the aftermath of WWII. If that trend

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[108] Ole Voss *The Impact of Investment Treaties on Contracts* at 318.

[109] For a relevant analysis, *see* Metallinos *The Greek Sovereign Debt Restructuring* at 26-28.

proves to be only temporary will much depend on the decisions that the two tribunals will reach on the merits.

B. State of Necessity Under General International Law

I. It has been previously stressed that necessity under general international law constitutes a secondary rule that regulates the conditions for a state to be held responsible for wrongful acts or omissions. Necessity under general international law is distinguishable from other formulations of the theory found either in international conventional law[110] or within domestic legal orders.

In the sovereign debt context, the possibility of a state successfully invoking necessity as a ground for precluding the wrongfulness of a default or debt restructuring could frustrate the attempts of its creditors to enforce their contractual rights before international and domestic courts or tribunals.[111] Evidently, this fact opens the door of abuse on the part of the sovereign debtor that could seek insulation from its liability in cases of opportunistic defaults. Of course, the possibility of abuse is not unique in the context of financial distress and sovereign debt crises, but has posed similar questions in other fields of international relations.[112] Throughout the 19th and early 20th century states regularly invoked necessity and a threat to their natural law right to "self preservation" as a political and moral excuse for open military interventions.[113] These abusive pleadings of the theory created a backlash in legal doctrine that ranged from an outright denial of its existence to its qualification to particularly stringent preconditions.[114]

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[110] In Bilateral Investment Treaties (BITs), Non Precluded Measures (NPM) Clauses provide for "public order" and "security" exceptions that allow host states to escape responsibility under the BITs' substantive standards of treatment *see* below page 32. In the context of the General Agreement on Tariffs and Trade, Article XXI offers an exception for the protection of "essential security interests".

[111] With regard to the invocation of the plea before domestic courts see the discussion above (page 4).

[112] Perhaps the classic case of such an abuse was the occupation of Luxembourg and Belgium by Germany in 1914, which Germany sought to justify on the ground of necessity. See, in particular, the note presented on 2 August 1914 by the German Minister in Brussels to the Belgian Minister for Foreign Affairs, and the speech in the Reichstag by the German Chancellor Von Bethmann-Hollweg, on 4 August 1914, containing the well-known words: "Wir sind jetzt in der Notwehr; und Not kennt kein Gebot!" (we are in a state of self defense and necessity knows no law). *See* International Law Commission's Articles on Responsibility for Internationally Wrongful Acts with Commentary [hereinafter ASRIWA], p.80, footnote 373. Among the most frequently cited historical cases in which necessity was invoked to justify annexations effected by recourse to war, mention may be made of that of the Free City of Krakow, annexed by Austria in 1846, the annexation of Rome by Italy in 1870 and the annexation of Ethiopia by Italy in 1936. "Necessity" was also invoked in 1908 by Austria-Hungary as justification for the annexation—effected by a show of force, but without war—of Bosnia-Hercegovina, province of the Ottoman Empire which had been placed under its administration by the Treaty of Berlin (13 July 1878), but sovereignty over which remained with Turkey. See the note sent by Austria-Hungary to the States signatories to the treaty in justification of the annexation, in British Documents on the Origins of the War, 1889-1914 (London, H.M. Stationery Office, 1928), vol. V, pp. 398 et seq. Cited *in verbatim* from the Addendum-Eight Report on State Responsibility by Mr. Roberto Ago, Special Rapporteur - The Internationally Wrongful Act of the State, Source of International Responsibility (part 1) [hereinafter Ago Report], p. 38, note 109.

[113] *Id* at 37-38.

[114] *Id* at 47.

STATE OF NECESSITY AND SOVEREIGN INSOLVENCY

The International Law Commission's (ILC) articles on State Responsibility for Internationally Wrongful Acts are widely accepted as reflecting customary international law on the area and offer a contemporary account of the conditions under which a pleading of necessity can preclude the wrongfulness of an act otherwise in violation of international law. To be sure, the ILC's articles echo some of the mistrust of the international community of the two previous centuries and thus, as will be shown later, they stress the exceptional nature of the plea.

Before entering into the main inquiry of this second part of the article regarding the substantiation of the necessity plea in cases of sovereign insolvency, a presentation of the findings of early international jurisprudence on necessity would be instructive in order to understand its origins and development. Particular emphasis is given on cases that dealt with financial necessity, while cases that occurred in different contexts are also considered due to their significance in the development of the theory.

Although international courts and tribunals that dealt with the question invariably confirmed the existence of a necessity defense under general international law, the conditions that attached to it were so onerous that as a practical matter preclusion of international responsibility was virtually impossible. Indeed, in a jurisprudence that spans from 1795 to 1939 it was only in one case that a defense of necessity was accepted by an international tribunal.

Perhaps the oldest case cited recognizing the existence of a state of necessity in international law is the *Neptune* case (1795). In this case the United States brought claims on the basis of the Jay Treaty against Great Britain for the capture of US vessel Neptune and its cargo in high seas during the British-French war.[115] Great Britain argued that it was threatened by scarcity of food due to the war and thereby the capture of the vessel was justified by necessity.[116] The mixed commission ruled that although "extreme necessity may justify the seizure of neutral property", the particular circumstances of the case did not correspond to an "extreme" or "irresistible" necessity.[117]

In the case of the *Russian Indemnity*[118], the Permanent Court of Arbitration declined to accept a state of necessity argument advanced by the Ottoman government[119] for the non payment of interest on bonds that Russian subjects received as war reparations according to a series of treaties that followed the Ottoman-Russian war of 1877-78. The Ottoman government claimed that events such as internal insurrections and wars amounted to a state of necessity, precluding the country's liability for default on interest payments.[120] The tribunal accepted the

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115 *Id* at 34.

116 *Id*

117 *Id*

118 *Russian Indemnity Case* (Russia v. Turkey) Award of the Arbitral Tribunal of 11 November 1912, 11 UNRIAA 431.

119 The argument was made under the term of *"force majeure"*, however, the Ottoman government was essentially pleading for what would be better described today as a state of necessity. This conflation between *force majeure* and necessity was commonplace in early jurisprudence and is found in most cases cited below.

120 Tigran B. Beknazar, *Russian Indemnity Arbitration,* Max Planck Encyclopedia of Public International Law (2011).

principle of necessity under international law,[121] however, it did not find that the events that the Ottoman government faced between 1881 and 1902 in fact constituted a peril to "the existence of the Ottoman Empire or seriously compromised its internal or external situation''.[122] The *Russian Indemnity* case is still considered a strong precedent for the exceptional nature of the necessity plea, especially due to the clarity of legal reasoning that characterizes the award.[123]

In 1931 Great Britain claimed that measures adopted by Belgium in what was then the Belgian Congo created a fluvial transport monopoly that benefited the Belgian company Unatra, contrary to the peace treaty of Saint-Germain.[124] The case was brought before the Permanent Court of International Justice (PCIJ) which held that no violation of the Saint-Germain convention had taken place.[125] The question of necessity was however addressed in the separate opinion of judge Anzilotto who expressly recognized the existence of the theory but also adopted a particularly restrictive position to its application. According to Anzilotto, the scope of a state's essential interests should be construed narrowly, while a violation of international law could be only excused in case of "impossibility of proceeding by any other method than the one contrary to the law".[126]

Socobelge[127] is another case of the era brought before the PCIJ that dealt with the question of necessity. In that case a Belgian financial firm, Societe Commerciale de Belgique, had obtained two arbitral awards against Greece that called for repayment of a debt that the Greek state had contracted with the company. Greece argued that the state's budgetary situation and external debt restructuring amounted to a state of necessity that made the execution of the awards impossible, notwithstanding the effect of *res judicata*.

The court did not examine the merits of Greece's necessity invocation, as it found that it did not have jurisdiction in ascertaining the country's financial condition and capacity to pay. Although the court's ruling offers no guidance with regard to the substantiation of the theory of necessity, the parties' pleadings are significant in that vein. Both countries accepted that, in principle, a state of necessity could preclude a state's responsibility for non payment of its debt obligations.[128] What is more, they did so by making reference to the essential state interest of "economic existence", which included "the normal functioning of public services", "social

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[121] In a famous statement made by the Russian government, "...[t]he obligation of a state to fulfill treaties may give away if the very existence of the state should be in danger, if the observance of the international duty is...self-destructive". Supra note 96, at 12-13.

[122] Supra note 120.

[123] *Id*

[124] Ago Report at 30.

[125] *Id*

[126] Ago Report at 31.

[127] *Societe Commerciale de Belgique*, 1939 PCIJ Series A/B, 160-90.

[128] *See* Ago Report at para. 30.

peace", as well as "public health and security".[129] This reasoning is much more liberal compared to natural law inspired ideas that were prevalent at that time and reduced the notion of "essential interest" to self-preservation. Another contribution of the case to the development of the doctrine of necessity relates to the temporary preclusion of international responsibility and its revival after the end of the state of affairs amounting to necessity. In that respect, the Belgian counsel argued that the invocation of necessity could not lead to the annulment of Greece's debt, but only to a postponement of payments, for so long as the conditions of necessity were in effect.[130]

It was mentioned above that the examination of early jurisprudence on necessity evidences only one case where an international court or tribunal discharged a state from liability due to a state of necessity. In *French Railroads Company of Venezuela*[131] the Permanent Court of Arbitration found that the ongoing civil war in Venezuela had created such threats to the preservation of the state that the country was required to commit its revenues to that purpose and to subordinate the claims of the French company for damages to its property due to hostilities. Hence, once more in this early jurisprudence, necessity was equated to the self-preservation of the pleading state.

The preparatory committee for the 1930 Hague Codification Conference dealt with the issue of international responsibility for non payment of sovereign debt obligations owed to foreigners and within this framework also considered whether a state of necessity could be invoked to preclude the wrongfulness of the relevant state act.[132] Although the particular basis of discussion submitted by the committee did not substantiate the term "financial necessity" and was later rejected by the Hague Conference, the submissions made by certain states signaled a departure from the natural law parity between necessity and self-preservation.[133]

It goes without saying that the precedential value of the case law cited above has been considerably diminished in light of the adoption of the ILC Articles. The ILC has indeed taken a different view on the character of the "essential interest" under threat in a state of necessity, something that should be accepted as evidence that customary international law has been developed towards a construction of the term that allows states to respond to situations falling short of a threat to their self-preservation. Thus, the importance of this early jurisprudence today lies not to the articulation of precise criteria against which state conduct should be evaluated, but to a spirit of constrain that invariably underlies all the cases and suggests that a state of necessity

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[129] *Id* paras. 28-9

[130] *Id* at para. 30.

[131] *French Company of Venezuela Railroads* (France v. Venezuela), French-Venezuelan Mixed Claims Commission (1902) 10 UNRIAA 285-355.

[132] Although the formulation used corresponds better to that of a primary rule of financial necessity. See page 3 above.

[133] See Ago Report at 24.

under general international law will be only accepted under exceptional circumstances.[134] At the same time, however, another important insight of the early jurisprudence on necessity is that courts and tribunals that dealt with the plea in the financial context accepted, even *in abstracto*, that necessity remains a ground for precluding wrongfulness where non fulfillment of international obligations has taken place due to economic constrains. It follows that the interpretation of the conditions set out in the relevant articles of the ILC should take place under the light of these observations.

II. A first issue that needs to be addressed before analyzing the requirements of a state of necessity pursuant to recent ICSID jurisprudence is the effects of non precluded measures clauses on the claims of investors seeking to trigger the international responsibility of the debtor state following a debt default or restructuring. Non precluded measures clauses allow parties to a BIT to escape responsibility for actions that would otherwise be in violation of the treaty's substantive terms where these actions were necessary to safeguard the host country's public order and essential security interests or the maintenance or restoration of international peace or security.

The non precluded measures clause provided in article XI of the US-Argentina BIT, that has been the subject of extensive litigation following Argentina's 2001 economic emergency measures, for instance provides that "[T]his Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the Protection of its own essential security interests." The significance of these clauses is considerable as a number of states of importance for international investment flows, such as the United States, Germany, the Belgian-Luxembourg Economic Union, India and most recently Canada, have concluded BITs containing non precluded measures clauses.[135]

A first issue that should be addressed with regard to the interpretation of non precluded measures clauses concerns their relation with the general international law defense of necessity, as this principle is reflected in article 25 of the ASRIWA. A number of early ICSID awards that dealt with the matter concluded that the two concepts are essentially identical, thereby inserting the stringent conditions of a state of necessity under general international law into the treaty standard of non precluded measures clauses.[136] According to the Annulment Committee in *Sempra*, this constituted failure to apply article XI of the US-Argentina BIT and amounted to a

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[134] In commenting this case law Sarah Heathcote notes "ces affaires...constituent plutot une condamnation implicite de l'etat de necessite en tant que regle de droit" Heathcote, S 2007, '*Est-ce que L'Etat de Necessite est un Principe de Droit Internatioanl Coutumier*, Revue Belge de Droit International vol. 2007, no. 1, pp. 53-89.

[135] William W. Burke-White and Andreas Von Staden *Investment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures Provisions in Bilateral Investment Treaties* 48 Va. J. Int'l L. 307 2007-2008 at 318 [hereinafter, White and Von Staden *Investment Protection in Extraordinary Times*].

[136] *CMS v. Argentina* at paras. 353-378, *Sempra v. Argentina* at para. 375-378, *Enron Corporation and Ponderosa Assets, L.P. v. Argentine Republic,* ICSID Case No. ARB/01/3 (also known as*: Enron Creditors Recovery Corp. and Ponderosa Assets, L.P. v. The Argentine Republic*) [hereinafter, *Enron v. Argentina*] at para. 333

manifest excess of powers pursuant to article 52(1)(b) of the ICSID convention.[137] The Annulment Committee in *CMS* on the other hand, while did not annul the award, intensely criticized the tribunal's approach.[138] In *LG&E* and *Continental* the tribunals concluded that the satisfaction of the conditions of a state of necessity under general international law and those of article XI of the US-Argentina BIT cannot be reduced to a single test.[139] Still, these two tribunals adopted elements of the general international law plea of necessity into their analysis of article XI of the US-Argentina BIT; in fact, both tribunals assessed whether Argentina contributed to the creation of a state of necessity, a test that is not part of article XI of the US-Argentina BIT *per se* but is a condition for the satisfaction of the general international law plea under article 25 2(b) of the ASRIWA.[140] By adopting a different rationale,[141] the *LG&E* and *Continental* tribunals concluded that Argentina did not contribute to the creation of the crisis and thus they absolved the country from responsibility on the basis of article XI of the US-Argentina BIT.

In a later award, the tribunal in *El Paso*[142] reached the opposite conclusion. The tribunal based the relevance of the "own contribution" test for the purposes of interpreting article XI of the US-Argentina BIT on the fact that there is a general rule of international law, as well as a general principle of law, that prohibits a party from invoking necessity when it has contributed to creating that necessity.[143] The tribunal stated that in ascertaining the meaning of article XI of the US-Argentina BIT was guided by Article 31 (3) of the Vienna Convention.[144] Thus, in sharp contrast to the awards in *LG&E* and *Continental,* the tribunal concluded that Argentina's own contribution to the situation of necessity prevented her from relying on the non precluded measures clause of the US-Argentina BIT.[145]

The award in *El Paso* constitutes an unfortunate setback to the early awards in *CMS, Sempra* and *Enron* that have read into article XI of the US-Argentina BIT the stringent tests of article 25 of the ASRIWA. To be sure, elements of this line of reasoning are found also in *LG&E* and *Continental,* notwithstanding that the two tribunals assessed in a different way the factual background of the Argentine crisis. In fact, the *El Paso* tribunal's reference to a passage from the *Amoco* case seems to advocate that article XI of the US-Argentina BIT functions as *lex*

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[137] *Sempra v. Argentina (decision on the application for annulment)* at paras. 197-203.

[138] *CMS v. Argentina (decision on the application for annulment)* at paras. 129-134.

[139] *LG&E v. Argentina*, ICSID Case No. ARB/02/1 (United States/Argentina BIT), Decision on Liability [hereinafter *LG&E v. Argentina*] at para. 206, *Continental v. Argentina* at para.167.

[140] *LG&E v. Argentina* at paras. 256, *Continental v. Argentina* at paras. 234-236.

[141] *Id*

[142] *El Paso Energy International Company v. The Argentine Republic*, ICSID Case No. ARB/03/15 (US/Argentina BIT), Decision on Jurisdiction [hereinafter *El Paso v. Argentina*].

[143] *El Paso v. Argentina* at paras. 617-624.

[144] *Id* at para. 624.

[145] *Id* at para. 656.

specialis to article 25 of the ASRIWA.[146] It is important to keep in mind though that, in the words of the ILC, "[i]t is not the function of the articles (that is the secondary rules provided by the ASRWIA) to specify the content of the obligations laid down by particular primary rules, or their *interpretation*".[147] Accordingly, pursuant to the view of the ILC, recourse to the ASRIWA in order to ascertain the meaning of treaty obligations according to Article 31 (3) of the Vienna Convention is only permissible when the interpretable treaty provision operates at the same level with the pertinent ASRIWA rule, that is when it constitutes a secondary norm itself. It then follows that the *El Paso* tribunal mistakenly conceived article XI of the US-Argentina BIT as a special secondary rule the meaning of which could be clarified as per Article 31 (3) of the VCLT by recourse to the *lex generalis* of article 25 of the ASRIWA. Given that non precluded measures clauses and the general international law defense of necessity operate at different levels as primary and secondary rules respectively, there is no ground for resorting to Article 31 (3) of the VCLT to determine the meaning of the former on the basis of the latter.

If recourse to the general international law concept of necessity is not appropriate for ascertaining the meaning of BITs' non precluded measures clauses, then the question arises of which interpretative method should be used. A first relevant inquiry is whether NPM clauses' references to "public order" and "essential security interests" cover exclusively civil unrests and national security concerns or if situations of economic necessity are also qualified. It appears in that regard that international jurisprudence has generally interpreted the notion of "security interests" rather liberally.[148] In the *Oil Platforms* case the ICJ noted that both the US and Iran recognized "some of the interests referred to by the United States -the safety of United States vessels and crew, and the uninterrupted flow of maritime commerce in the Persian Gulf- as being reasonable security interests of the United States".[149] This permissive to economic concerns interpretation of "security interests" has been consistently followed by the ICSID tribunals that examined the emergency measures of Argentina in the context of its 2001 financial collapse.[150]

Another issue that may give rise to interpretative perplexity concerns the nexus requirement that needs to be established between regulatory measures and protected policy interests under non precluded measures clauses. In that regard, the language used in each treaty should be the starting point of every interpretative exercise; to be sure, investment treaties use variant formulations in order to establish the necessary nexus between state action and legitimate

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[146] *Id* at para. 616.

[147] ASRIWA, at 31 para. 4

[148] For a different view *see* Jose Alvarez and Kathryn Khamsi *The Argentine Crisis and Foreign Investors A Glimpse into the Heart of the Investment Regime* The Yearbook of International Investment Law and Policy 2008-2009 edited by Karl P. Sauvant at 449-455.

[149] Oil Platforms (Iran v. U.S.), Judgment, 2003 I.C.J. (Nov. 6) at 196

[150] *LG&E v. Argentina* at para 238, *CMS v. Argentina* at para 331-332, *Enron v. Argentina* at para 332, *Sempra v. Argentina* at para 374.

policy objectives. US practice for instance requires measures to be "necessary", while the New Zealand-China BIT uses the more open ended phrase "directed to".[151]

In interpreting a non precluded measures clause in the US-Nicaragua FCN treaty, the ICJ applied a strict nexus requirement by holding that "[t]he measures taken must not merely be such as tend to protect the essential security interests of the party taking them, but must be 'necessary' for that purpose".[152] The court later confirmed its view in *Oil Platforms* in the context of the US-Iran FCN, in a case that involved the use of force in potential violation of article 2(4) of the UN Charter. As White and Von Staden note, however, the broader context within these ICJ rulings took place was the use of force and its legality in *jus ad bellum,* and as such, extrapolating the restrictive reading of "necessary" by the ICJ to the field of investment treaty arbitration is not appropriate. The same authors argue for more lenient standards of interpretation, such as the ECtHR "margin of appreciation" analysis or the "less restrictive means" approach, that would essentially shift the risks of state action in exceptional circumstances from host states to investors.[153] The tribunal in *Continental* in fact expressly adopted the "least restrictive means" test in ascertaining the content of "necessary" for the purposes of article XI of the US-Argentina BIT by drawing parallels with WTO jurisprudence on article XX of the GATT.[154] Although Argentina was absolved from responsibility with regard to the *Corralito* (the imposition of the bank freeze), the devaluation of the *Peso* and the *pesofication* of dollar liabilities,[155] the restructuring of certain government securities did not satisfy the "less restrictive means" standard[156]. This stresses that sovereign debt defaults and restructurings may not be considered as measures that are necessary to achieve the protected objectives of NPM clauses even where more permissive to state action interpretations were to be used.

The interpretation of NPM clauses' "necessary" language that White and Von Staden argue for is in fact very similar to the public law standards of review that will be analyzed below in the context of article 25 ASRIWA. This, however, does not neglect the independent standings of the treaty and general international law concepts of necessity, neither constitutes inappropriate "interpretative application" of the ILC standard via Article 31 (3) of the VCLT. Indeed, the other stringent requirements of article 25 ASRIWA, such as the "own contribution" test, should remain irrelevant when interpreting a boilerplate non precluded measures clause.

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[151] White and Von Staden *Investment Protection in Extraordinary Times* at 37.

[152] *See* Military and Paramilitary Activities in and Against Nicaragua (Nicaragua v. U.S.), 1986 I.C.J. 14, 15 (June 27) at 141.

[153] White and Von Staden *Investment Protection in Extraordinary Times* at 41.

[154] *Continental* at para.192

[155] *Id* at paras 201-214.

[156] *Id* at paras 220-221.

III. A successful invocation of the necessity plea under general international law requires the cumulative satisfaction of the stringent conditions stipulated in article 25 of the ASRIWA.[157] The extended case law of ICSID tribunals on the Argentine crisis clearly demonstrates that the satisfaction of some of these conditions in the context of a sovereign debt crisis pose a particularly high threshold to the pleading state. These conditions relate to the requirements that the invoking state did not have any other way to safeguard its essential interests (only way requirement)[158] and of non contribution to the situation of necessity (own contribution requirement)[159]. Because of the particular difficulty that the two requirements are likely to cause to the substantiation of a necessity plea in cases of sovereign insolvency, the following lines present in some detail the positions taken by ICSID tribunals so far.

With regard to the only way requirement, an overwhelming majority of tribunals held that the emergency measures enacted by Argentina as a consequence of its dramatic economic meltdown were not the only way to deal with the crisis.[160] In all these cases tribunals heard expert opinions by distinguished economists that proposed a number of alternative economic policy measures that would have not affected investors' interests so drastically.

Regarding Argentina's own contribution to the crisis, an equally large number of tribunals ruled that external causes may had been an important factor in the creation of the crisis, but poor domestic economic and fiscal policies were at least equally important.[161] Thus, Argentina's contribution to the state of necessity was deemed substantial, thereby precluding a successful invocation of the plea.

Against this vast and uniform case law, there are three cases, *LG&E*, *Continental* and *Enron Annulment*,[162] suggesting -in one way or the other- that the general international law plea of necessity can be accepted in the context of financial crises.

The award in *LG&E* is often cited as one of the very rare cases in international jurisprudence that a necessity defense under general international law is being accepted. A

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[157] *Gabcikovo-Nagymaros Project* (HungarylSlovakia), Judgment, I.C.J. Reports 1997, p. 7.

[158] According to article 25 1(a) of the ASRIWA, "Necessity may not be invoked... unless the act is the only way for the State to safeguard an essential interest against a grave and imminent peril".

[159] According to article 25 2 (b) of the ASRIWA, "In any case, necessity may not be invoked by a State as a ground for precluding wrongfulness if the State has contributed to the situation of necessity".

[160] *CMS v. Argentina* at paras. 323-324, *Sempra v. Argentina* at paras. 350-1, *Enron v. Argentina* at paras. 307-309, *Suez, Sociedad General de Aguas de Barcelona S.A., and InterAguas Servicios Integrales del Agua S.A. v. The Argentine Republic*, ICSID Case No. ARB/03/17) at para. 238 [hereinafter, *Suez v. Argentina*], *Total S.A. v. The Argentine Republic*, ICSID Case No. ARB/04/01 at paras. 223, 345, 483-4 [hereinafter, *Total v. Argentina*], *EDFI et al. v. Argentina* ICSID Case No. ARB/03/23 at para.1172 [hereinafter, *EDFI v. Argentina*].

[161] *CMS v. Argentina* at para. 329, *Sempra v. Argentina* at para. 354, *Enron v. Argentina* at paras. 311-13, *Suez v. Argentina* at 241, *EDFI v. Argentina* at paras. 1173-76, *Impregilo S.p.A. v. Argentine Republic*, ICSID Case No. ARB/07/17 at para.358, *National Grid plc v. The Argentine Republic*, UNCITRAL at para. 260.

[162] *Enron v. Argentina* (Decision on the Application for Annulment).

careful reading of the award reveals however that the determining factor in that case was the operation of Article XI contained in the US-Argentina BIT. To be sure, the tribunal indeed accepted that the conditions of the necessity plea had been satisfied in the present case, but quite evidently it did so as a matter of *dicta*.[163] Even more importantly, the tribunal in *LG&E* has been widely criticized for not engaging in a substantive analysis of the requirements of the necessity plea according to the ILC Articles, thereby serving as a rather poor precedent.[164]

The analysis of the substantive conditions of the necessity plea by the Annulment Committee in *Enron*, on the other hand, is much more detailed and well reasoned. In relation to the only way requirement, the Annulment Committee criticized the *Enron* tribunal for adopting a literal interpretation of article 25 ASRIWA without considering its other potential interpretations.[165] The Committee argued that the tribunal's reading of article 25 ASRIWA, pursuant to which the mere existence of alternative economic policies precludes the operation of the necessity plea, led it to substitute its legal judgment regarding the evaluation of the conditions of article 25 ASRIWA with an expert testimony that could merely confirm the availability of alternative economic policies.[166] In essence, the Committee suggested that in interpreting article 25 ASRIWA the tribunal had to adopt a more flexible standard of review instead of embarking into a rigid literal interpretation.

Quite significantly, and in contrast with previous ICSID case law, the Committee proposed an interpretation of article 25 ASRIWA pursuant to public law standards of review of governmental acts, such as the less restrictive means analysis and the margin of appreciation doctrine.[167] As will be shown below, the Committee's rationale can be better understood as proposing a uniform standard of review that combines elements of both the less restrictive means analysis and the margin of appreciation doctrine.

With regard to the issue of a state's own contribution to the situation of necessity, the Annulment Committee in *Enron* once more argued that the tribunal merely applied an expert testimony on an economic question instead of engaging in a legal analysis of the requirements of article 25(2)(b) ASRIWA.[168] According to the Committee, the fact that the pleading state's actions objectively contributed to the state of affairs amounting to necessity does not negate the

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[163] *See LG&E v. Argentina at* para. 245 "While the Tribunal considers that the protections afforded by Article XI have been triggered in this case, and are sufficient to excuse Argentina's liability, the Tribunal recognizes that satisfaction of the state of necessity standard as it exists in international law (reflected in Article 25 of the ILC's Draft Articles on State Responsibility) supports the Tribunal's conclusion."

[164] Michael Waibel *Two Worlds of Necessity in ICSID arbitration: CMS and LGE* Leiden Journal of International Law (2007) pp 637-648 at 642 [hereinafter Waibel *Two Worlds of Necessity*], A. Reinisch, *'Necessity in International Investment Law – An Unnecessary Split of Opinions in Recent ICSID Cases? Comments on CMS v. Argentina and LGE v. Argentina'*, (2007) 81 Journal of World Investment 191 at 12.

[165] *Enron Annulment* at para 369.

[166] *Id* at paras. 376-377

[167] *Id* at paras. 370, 371, 372

[168] *Id* at para. 393

operation of the plea. A further subjective element is required, according to which a certain degree of fault on the part of the state should be established.[169]

The tribunal in *Continental* on the other hand examined the question of Argentina's own contribution to the crisis in the context of a non precluded measures clause and found that the country could not be barred from invoking article XI of the Argentina-USA BIT because of the adoption of presumably unsound economic policies.[170] What is significant in the tribunal's rationale is the suggestion that to the extent that domestic economic policies are supported by the international financial community (as was the case with the official support of Argentina's currency board by the IMF and the US government for instance), the pleading state cannot assume ultimate responsibility for their failure and eventual creation of a crisis.[171]

IIIa. The findings in Enron Annulment and Continental with regard to Argentina's own contribution to the crisis and the only way requirement introduce elements of flexibility in the general international law doctrine of necessity that are needed in order to make it operable in situations of financial distress. Be that as it may, these findings are isolated instances in an otherwise uniform ICSID jurisprudence that has consistently negated the availability of the defense of necessity in the context of the Argentine crisis. Therefore, as a practical matter, a turn of this trend in ICSID case law should not be expected in the foreseeable future. Still, it is suggested that by turning to the decisions in Enron Annulment and Continental future tribunals and other adjudicatory bodies dealing with sovereign debt crises will gain valuable insight in balancing creditors' rights with debtor states' essential interests. This issue is further examined below.

Starting with the Enron Annulment Committee's public law approach to the only way requirement of article 25 ASRIWA, one may challenge the appropriateness of introducing flexible standards of review such as the least restrictive alternative or the margin of appreciation analysis in the context of a general international law doctrine that has been purposefully drafted in a particularly restrictive manner.

Still, there may be cases where judicial authorities owe a certain degree of deference to governmental organs for reasons of improved institutional capacity or even democratic

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[169] *Id* at para. 389

[170] *Continental v. Argentina* at paras. 234-236. The tribunal stated however that the evaluation of "own contribution" in the context of NPM clauses differs from that applied in the general international law standard.

[171] *Id* at paras. 235-236.

legitimacy.[172] Accordingly, where adjudication touches upon sensitive issues posited at the core of societal and constitutional organization, such as a state's ability to provide for vital public services, deferential standards of review of governmental measures can be seen as an appropriate mechanism to reconcile a state's essential interests with its international obligations. It appears therefore, that there is no compelling reason why economic emergency measures could not be reviewed in a similar way in order to assess whether the conditions of the necessity plea have been satisfied.

In fact, it has been supported that article 25 ASRIWA constitutes a type of "inherently flexible standard-type norm", for which deferential standards of review are indeed appropriate;[173] a closer reading of the only way requirement arguably supports this proposition.

More concretely, article 25 1(a) allows the invocation of necessity if a measure is the only way to *safeguard* an essential interest. At the same time, the commentary to the Articles notes that the plea is precluded if there are other means to do so, even if they are "more costly or less convenient".[174] However, the cost or inconvenience that the alternatives involve are tolerable as long as they do not impede the essential interest under protection itself. [175]

The tribunals that rejected the operation of the necessity defense on the grounds of non satisfaction of the only way requirement, failed to assess the relative effectiveness of different policies in actually safeguarding Argentina's essential interests. As mentioned above, for these tribunals the mere existence of alternative measures with less significant effects on investors sufficed to negate the defense.

The Annulment Committee indeed criticizes the Enron tribunal exactly on that ground, by stating that "[A] second question not addressed by the Tribunal is whether the relative effectiveness of alternative measures is to be taken into account".[176] While the Committee appears to propose three alternative interpretations to the "only way requirement" that the

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[172] Reasons of institutional capacity refer to the idea that courts are sub-optimal decision makers compered to state bureaucracies. While courts "adopt decisions in the context of a specific dispute, on the basis of information supplied to them by the parties, and through the prism of legal norms (which often reflect social interests in an unsatisfactory manner)", executive agencies "continually monitor situations and address them utilizing a variety of inter-disciplinary tools, incorporating a variety of short-term and long-term interests". Reasons of democratic legitimacy relate to the inherent democratic deficit of judicial authorities; "since domestic and international courts are comprised of non directly-elected individuals, their suitability to make important choices regarding social conditions within states is controversial. Arguably, such choices should be taken, whenever possible, by democratically elected officials, i.e., the government apparatus, through a process of public deliberation." Yuval Shany *Towards a General Margin of Appreciation Doctrine in International Law?* EJIL (2005), Vol. 16 No. 5, 907–940 at 919-920 [hereinafter, Shany *Towards a General Margin of Appreciation Doctrine in International Law?]*.

[173] Shany *Towards a General Margin of Appreciation Doctrine in International Law?* at 914-915 and accompanying note 46. According to Shany, "resort to standard type norms reduces legal certainty, since their application is always circumstance-dependent", on the other hand, their use over black letter rules constitutes a "political choice" that "marks a preference for pluralism and diversity over uniformity in law application, and the empowerment of decentralized national decision makers at the expense of their international counterparts".

[174] ASRIWA para. 15.

[175] Roman Boed *State of Necessity as a Justification for Internationally Wrongful Conduct* 3 Yale Hum. Rts. Dev. L.J. 1 2000 at 18.

[176] *Enron Annulment* at para. 371.

tribunal had to consider,[177] the Committee's rationale can be better understood by unifying these apparently different interpretations. It is therefore argued that the best way to approach the only way requirement of Article 25 ASRIWA is through a hybrid standard of review that combines elements of the margin of appreciation doctrine and the least restrictive alternative analysis. Accordingly, a first step is the evaluation of the relative effectiveness of different economic policies in safeguarding a particular state interest. This in turn presupposes the determination of a level of protection accorded to an essential interest under threat. At that stage, a margin of appreciation -arguably wide- could be given to the pleading state to determine the desired level of protection.[178] Once this level has been established, the state would be able to adopt those policies capable of achieving the desired level of protection, and in case that two or more policies are equally capable of doing so, it would be required to opt for those that involve the minimum violation of international law. Importantly, the state's assessments will always be subject to a residual good faith and reasonableness review,[179] a standard that, although significantly lenient, can insulate against abusive invocations of the plea.

The Annulment Committee in Enron also struck down the tribunal's finding that Argentina's contribution to the crisis precluded the invocation of the necessity defense. As already mentioned, the Committee essentially read in Article 25 2(b) ASRIWA an element of fault as a prerequisite of a determination that a state contributed to the situation of necessity. To be sure, this approach echoes the view expressed by the International Law Association, according to which "[i]n a judicial proceeding, this rule (then Article 33 2(c) of the ILC Draft Articles, the predecessor of Article 25 2(b)) would force a court to determine whether the debtor State had acted in deliberate disregard of generally held views and had foreseen or should have foreseen that it would be unable to repay the loan".[180]

The tribunal in Continental adopted a similar line of reasoning in applying the "own contribution" requirement. According to the tribunal's rationale, Argentina's rigid monetary policy (in particular the peg of the peso to the US dollar), its loyal application of IMF prescriptions and broader subscription to the "Washington Consensus" rulebook prior to the

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177 *Id* at paras. 370-72.

178 Pursuant to the elaborate jurisprudence of the ECtHR, the scope of the margin of appreciation accorded to national authorities depends particularly upon: a. the comparative advantage of local decision-makers; b. indeterminacy of the applicable standard -the greater the degree of European consensus over a particular matter, the narrower the margin that is accorded-; c. nature of the contested interests. Brems, '*The Margin of Appreciation Doctrine in the Case Law of the European Court of Human Rights*', 56 Heidelberg J Int'l L (1996) 240, at 256.

179 See Shany *Towards a General Margin of Appreciation Doctrine in International Law?* at 910-911. For an analysis of the good faith review, *see* William W. Burke-White and Andreas von Staden *Private Litigation in a Public Law Sphere: The Standard of Review in Investor-State Arbitrations* 35 Yale J. Int'l L. 283 2010 at 311-314.

180 Report of the International Law Association Committee on International Monetary Law, 1988 Warsaw at 430-431.

adoption of the emergency measures, precluded the suggestion that the country contributed to the crisis.[181]

Such permissive to the pleading state readings of the own contribution requirement of Article 25 2(b) ASRIWA are in congruence with the view that the capacity of ICSID tribunals to substitute their judgment for a country's economic policies is tenuous[182]. Furthermore, it is not difficult to see that a literal interpretation of Article 25 2(b) ASRIWA would not only render it inapplicable in cases of sovereign debt distress but would also result in absurd outcomes; accordingly, a state could be precluded from invoking necessity merely because it issued debt in the first place. From a doctrinal perspective, this would turn basic interpretative canons on their head. Although the ASRIWA do not constitute treaty obligations, that does not preclude the application of established rules of treaty interpretation in ascertaining the meaning of the general international law rules they reflect.[183] Accordingly, the customary rule of necessity should be construed on the basis of the cardinal principle of effective interpretation (*ut res magis valeat quam pereat*), that is in a way that incarnates its object and purpose. The very essence of the necessity plea is to inject flexibility into international obligations so to allow for derogation under exceptional circumstances, while safeguarding against abusive invocation. Given that a literal interpretation of Article 25 2(b) ASRIWA would devoid the rule of any meaning in cases of financial crises, recourse should be sought to an interpretation that would make necessity operable in situations of serious economic distress. This view is corroborated by the findings of the early jurisprudence on necessity that consistently accepted that, as a matter of principle, the plea should be available in the context of economic crises.[184]

It would then follow, that "substantial contribution" to the situation of necessity under Article 25 2(b) ASRIWA should not be interpreted in a strictly objective manner. States should not be precluded from invoking necessity merely because otherwise reasonable and *bona fide* economic policies eventually miscarried. In an environment where domestic economic policies are continuously monitored by supranational authorities it is perfectly plausible to gauge reasonableness and diligence in economic policy planning: adjudicatory bodies can reach informed decisions in that vein by turning to IMF article IV surveillance reports or to recommendations issued under article 121 of the TFEU. Where a financial crisis has been preceded by consistent disregard by the national authorities of economic policy advice, that would furnish important evidence of unsound economic management and could preclude the invocation of necessity.

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[181] The *Continental* tribunal made the explicit qualification that its analysis applied to the interpretation of the NPM clause of the Argentina-USA BIT and that the requirements of the general international law plea of necessity are not the same. It has been already mentioned that the insertion of the customary "own contribution" requirement into the treaty standard of NPM clauses is erroneous.

[182] Waibel *Two Worlds of Necessity* at 648.

[183] Alexander Orakhelashvili THE INTERPRETATION OF ACTS AND RULES IN PUBLIC INTERNATIONAL LAW *The Interpretation of Customary Rules* OUP 2008 at 497. For a different view *see* Anastasios Gourgourinis *The Distinction between Interpretation and Application of Norms in International Adjudication* Journal of International Dispute Settlement, Vol. 2, No. 1 (2011) at 36.

[184] See the examination of the early case law on necessity at pages 27-31 above.

IV. This final section addresses the question of which would be a court's approach to a necessity defense advanced by a country that has defaulted on or restructured its debt contrary to its international obligations under the light of the ASRIWA and relevant jurisprudence. It is argued that the possibility of invoking necessity should remain open to distressed sovereign debtors. Still, it is further suggested that such a conclusion is in no way panacea for the resolution of sovereign debt crises. This is so because even if the defense were to be accepted *in casu*, its built-in limitations would preclude a comprehensive solution of the debtor county's problems.

As a first step, a court assessing the satisfaction of the substantive conditions of the plea in the context of sovereign insolvency should examine whether continuing servicing the debt normally represents a grave and imminent peril to the debtor country's essential interests. According to the ILC, the notion of "essential interest" cannot be substantiated in the abstract, that is there is not a *numerus clausus* of interests that are qualified as essential. On the contrary, the evaluation of protected state interests under article 25 ASRIWA should take place on a case by case basis.[185] Hence, a "wide variety" of interests are potentially protected, such as "safeguarding the environment, preserving the very existence of the State and its people in time of public emergency, or ensuring the safety of a civilian population".[186]

ICSID tribunals that dealt with the question of whether a sovereign debt crisis puts at risk the state's essential interests in the context of the Argentine crisis, connected that issue with an assessment of the severity of the crisis that the state faces.[187] While a number of tribunals found that the standard would be satisfied only if a "compromise to the very existence and independence" of the state existed,[188] others adopted a more lenient approach and ruled that Argentina's essential interests were indeed threatened.[189] Still, this dichotomy in ICSID jurisprudence may only be apparent, given that even those tribunals that did not find that an essential interest of Argentina was in peril, in fact went on to examine the other requirements of article 25 ASRIWA . That could be interpreted as an implicit acceptance that an essential interest of the country was actually affected.[190] Besides, it has been also suggested that the determination

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185 ASRIWA at 83.

186 *Id.*

187 *CMS v. Argentina* paras. 319-322, *Enron v. Argentina* paras. 305-307, *Sempra v. Argentina* paras. 348-349.

188 *Id*

189 *LG&E v. Argentina* at para. 257, *Impregilo S.p.A. v. Argentine Republic*, ICSID Case No. ARB/07/17 at paras. 346-350, *Suez, Sociedad General de Aguas de Barcelona S.A., and InterAguas Servicios Integrales del Agua S.A. v. The Argentine Republic*, ICSID Case No. ARB/03/17 at para 238.

190 *Enron Annulment* at para. 359.

of a particular interest as essential is in fact highly subjective and essentially lies within the state's domestic jurisdiction.[191]

As it has been aptly put, sovereign insolvency is a spoliator, a destroyer;[192] it results in the drying up of the whole economy, as trade, investment and credit shrink. After a while, even the most basic functions of a state may be in question. Excluding rare instances of opportunistic debtor behavior, the state's most essential interests are indeed on the table. As demonstrated in the previous lines, this is also supported by theory and case law.

Still, a caveat may apply here; where default occurs after a negotiated debt restructuring that has presumably restored the country's solvency and has improved its general macroeconomic position, the stakes may no longer be that high to justify the assumption that an essential interest is in imminent peril. This is very important because most of the litigation on sovereign debt takes place post restructuring by holdout creditors that essentially seek to benefit from the concessions of participating creditors. Still, post restructuring defaults are not likely to be legion as countries have already reduced their debt burden.

Another question that could be raised at that point is whether the court should focus on the isolated effect on the state's financial condition of the amount owed to the particular creditor that took legal action or to the state's overall indebtedness. If the former approach were to be followed, the result would be full repayment of the state's debts and, ultimately, the creation of a state of necessity due to the state's inability to invoke the rule which was supposed to protect it from that eventuality.[193] That would be contrary, however, to the very spirit of the necessity defense which is essentially preventive.[194] Thus, a court would have to assess the peril to the country's economic viability *vis a vis* its overall debt stock.

Next, the court would examine whether the default or restructuring was the only way to safeguard a given essential interest. Following the test outlined above,[195] the pleading state would determine a reasonably desired level of protection for the essential interest at stake. Subsequently, it would have to provide evidence that the desired level of protection could not have been achieved by diverting budget resources (without thereby threatening other essential interests) or by imposing smaller losses to creditors. The court then would decide on the basis of the evidenced provided whether the quantum of losses that creditors suffered is tolerable. Importantly, in making this decision the court would be bound by the country's determination of the degree of protection accorded to its essential interests, which would serve as a proxy of the appropriate debt relief that the country will ultimately receive.

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[191] Sarah Heathcote *Circumstances Precluding Wrongfulness: Necessity* at 497. The author notes that this subjectivity is limited by a good faith requirement, pursuant to which a social consensus among the international community should exist that the protected interest is indeed "essential".

[192] ILA 2010 Report page 6.

[193] ILA 1988 Report of the Committee on International Monetary Law at 431.

[194] Paragraph (16) of the ASRIWA states that "By definition, in cases of necessity the peril will not yet have occurred".

[195] See at page 39.

The next step of the court would be to weigh the debtor state's interests with those of the state(s) to which the obligation is owed or of the international community as a whole, pursuant to article 25 1(b) ASRIWA. The most intriguing question regarding this provision is whether the interests of individuals and juridical persons (especially firms) are to be taken into account in the balance. According to article 33 paragraph 2 of the ASRIWA, non state actors are not precluded from invoking the protections of the secondary rules, subject to the scope of the primary obligation in question. To be sure, international jurisprudence has allowed the possibility of individuals effectively being the direct holders of rights established under treaties at the interstate level.[196]

It appears that this would be indeed the case in the context of investment related disputes where investors are the ultimate beneficiaries of protections under international investment agreements.[197] Furthermore, the reference to "the international community as a whole" of section (b) constitutes a flexible wording that has been purposely used in order to accommodate the interests of both states and private law persons.[198]

The findings of tribunals on the Argentine crisis lack a balancing test between the essential interests of the pleading state, on the one hand, and those of investors on the other. Instead, the tribunals only inquired if damages to investors' interests amounted to a harm to the interests of their home countries and expressly negated such possibility.[199] Although this approach neglects the reference made in article 25 1(b) to the interests of the "international community as a whole", it is rather certain that even if the right test was applied the balance would tilt in favor of the pleading state. Indeed, it is hard to imagine how even the most essential interest of an investor could outweigh a state's interest to its economic survival.

Then, the court would move to examine if the international obligation in question excludes (explicitly or implicitly) the invocation of necessity, as per Article 25 2(a) ASRIWA. Explicit exclusion is part of certain humanitarian conventions, whereas implicit exclusion may

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196. *LaGrand Case* (Ger. v. U.S.), Merits (Int'l Ct.Justice June 27, 2001) at para. 77, *Jurisdiction of the Courts of Danzig*, Advisory Opinion,1928 PCIJ (ser.B) No.15, at 17-19 (Mar.3).

197 James Crawford, *The ILC's Articles on Responsibility of States for Internationally Wrongful Acts: A Retrospect*, AJIL, Vol. 96, No.4 (2002) pp.874-890 at 888 [hereinafter Crawford *The ILC's Articles on Responsibility of States for Internationally Wrongful Acts: A Retrospect*]. For a more detailed analysis of the debate regarding the direct or derivative character of investors' rights pursuant to international investment agreements *see* Zachary Douglas *The Hybrid Foundations of Investment Treaty Arbitration' (*2003) Vol. 74 British Yearbook of International Law, Martins Paparinskis *Investment Treaty Arbitration and the (New) Law of State Responsibility* EJIL (2013), Vol. 24 No. 2, 617–647.

198 James Crawford, *The ILC's Articles on Responsibility of States for Internationally Wrongful Acts: A Retrospect* at 888.

199 The tribunals in *Enron* and *Sempra* were apparently more accommodative to investors' interests in that regard in noting that "[i]n the context of investment treaties there is still the need to take into consideration the interests of the private entities who are the ultimate beneficiaries of those obligations...The essential interest of the Claimants would certainly be seriously impaired by the operation of Article XI or state of necessity in this case". *Enron* para. 342, *Sempra* para. 391. Still, it appears (although the relative rationale is somehow blurred) that the tribunals considered the interests of investors not legally significant in the context of Article 25 1(b). The tribunal in *Impregilo* noted that "[T]he interests of a small number of a Contracting State's nationals or legal entities are not consistent with or qualify as an "essential interest" of that State". Para 354. Similarly, the tribunal in *Suez*. at para. 239.

be inferred from the object and purpose of a rule.[200] An argument could be made in this regard that the protections of international investment agreements establish such rules, given that it is in times of emergency that their protection is more needed to investors. Although this is indeed accurate as far as typical risks associated with general regulatory interests of the host state are concerned,[201] the case would be different in exceptional circumstances of crisis under which the general international law doctrine of necessity would normally operate. Therefore, the object and purpose of investment agreements cannot be interpreted as implicitly precluding a plea of necessity. This is indeed corroborated by the findings of tribunals regarding Argentina that almost invariably support that assumption.[202]

As a final step, the court would be required to assess the last condition of Article 25 of the ASRIWA regarding the state's own contribution to the situation of necessity. The ILC in its commentary of the ASRIWA makes clear that contribution should be distinguished from causation and that only the former is required for the purposes of Article 25 2(b).[203] Accordingly, even if exogenous factors were effectively the cause for the creation of a sovereign debt crisis - financial contagion from another region or speculative flows of external capital for instance- that would not absolve the state from responsibility, as long as domestic policies had already created important vulnerabilities that became apparent only after an external shock.[204] As the vast majority of the tribunals that examined the Argentine crisis noted, financial crises will almost

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[200] ASRIWA with commentary at page 84.

[201] Given that "[t]he purpose of investment treaties is to address the typical risks of a long-term investment project". Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law*, at 22.

[202] There is only one case under the UNCITRAL rules that a tribunal reached a different conclusion on that issue, *BG Group Plc. v. The Republic of Argentina*, UNCITRAL at para 409. The tribunal in *CMS* also approached the matter with some skepticism, without being clear what was its final conclusion, see paras. 354-355.

[203] ASRIWA page 78 para (9).

[204] In the IMF's assessment of the causes of the Argentine crisis carried out by the Independent Evaluation Office, a distinction is made between immediate factors triggering a crisis and underlying vulnerabilities: "[I]t is difficult to isolate, from the many factors involved, those that were fundamentally more important. It is possible, however, to distinguish between the underlying factors that generated vulnerability and the immediate factors that triggered the crisis. In the absence of triggering events, a crisis may not have occurred when it did, but the underlying vulnerability would have continued and a crisis could have been triggered later by other adverse shocks. In the absence of the underlying vulnerability, however, the same adverse event would not have had the catastrophic effects that were associated with the crisis, though they may well have produced some negative effects". *See* IMF Independent Evaluation Office, *Evaluation Report: The IMF and Argentina, 1991-2001* (2004)

certainly be the outcome of an interplay between domestic and external factors.[205] As it was argued above, however, there are both policy and doctrinal objections to a literal and strictly objective interpretation of Article 25 2(b) ASRIWA. Accordingly, "substantial contribution" of the pleading state to the creation of necessity by virtue of internal economic policy failures should not be lightly assumed. *Bona fide* and reasonable economic policies that have the seal of approval of international watchdogs such as the IMF and the European Commission cannot be deemed as "contributions" to a state of necessity merely because they did not bring about the expected outcomes. Economics is more an art than a science and what seemed as optimal regulatory action *ex ante* may well be proved flawed *ex post*. The view advocated here has also the added advantage of improving the accountability of international institutions charged with supervising national economic policies. Although international agencies will not be held directly responsible for ill advising national authorities, it would be much more difficult to put the blame of financial failure exclusive on debtor states that have acted pursuant to their instructions.

In case there was a conclusion that the state has satisfied all the conditions of Article 25, article 27 would come into play. Article 27 (b) addresses the question of whether the burden of non compliance with an international obligation should be borne by the invoking state or rather by the party to which the duty is owned. Accordingly, the invoking state may be liable to provide compensation for any material loss suffered by the beneficiary of the obligation. However, section (b) merely allows for that possibility without providing for the circumstances under which compensation should be paid.[206]

It is suggested that in cases where non compliance with international obligations has taken place due to financial necessity, and at the time of the judgment there is no significant improvement of the financial position of the state, it would be contradictory on the one hand to excuse such non compliance and on the other to require compensation for it. In fact, if the state is asked to provide compensation in case of a sovereign default or debt restructuring, any relief gained through necessity would be nullified as it would have to subsequently return the equivalent amount to creditors as compensation.

Article 27 (a), on the other hand, poses a more significant limitation. Accordingly, preclusion of wrongfulness is temporary as the international obligation in question is revived

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[205] The experiences of the Asian financial crisis (1997) and the European debt crisis more recently indeed support this conclusion. In the Asian crisis, the trigger was the massive withdrawal of external capital, after an equally abrupt inflow of Western investors' money; still, most of the South-East Asian economies were already beset with crony relations between the state and the private sector of the economy, particularly the banking system. The general pattern was more or less the same in the case of Greece. The main external factor in that instance was investors' oversensitivity regarding high indebtedness after the collapse of Lehman Brothers. Greece, on the other hand, had a public debt in the region of 100% of its GDP and consistently run extensive budget and trade deficits. These two factors -external and domestic- were combined and resulted in a sell-off of Greek debt that ultimately resulted in its restructuring. Reinhart & Rogoff also argue that domestic economic fundamentals were a major factor for the spread of the US subprime crisis to countries like Bulgaria, Iceland, Ireland, Latvia, New Zealand, Spain and the UK. *See This Time is Different* at 244.

[206] ASRIWA at page 86.

when the state of necessity ceases to exist.[207] Thus, necessity can only lead to a postponement of international duties and not to their termination. Therefore, by the time necessity no longer subsists, the state would be required to continue servicing its debt regularly. This means that excessive indebtedness is not addressed *per se* by necessity, as only temporary moratoria and not write-offs of debts are covered by the plea. Consequently, a successful invocation of necessity can merely offer some breathing space for the state and probably additional leverage in the negotiations with its creditors. Alas, a comprehensive solution of its owes can be only achieved through debt reduction, for which necessity is not a substitute. To the extent that the state values its international legal obligations, such reduction can only come through negotiated solutions with its creditors.

C. Conclusion

The preceding discussion has demonstrated that the general international law defense of necessity poses a very high threshold of satisfaction for debtor states seeking to invoke it in cases of insolvency. This is hardly surprising considering that the doctrine was originally developed in the context of *jus ad bellum* and thus the codification of the customary principles made by the ILC reflects the concern towards abusive recourse to armed force, a recurring event during the 19th and early 20th century. Still, a case law spanning from the *Russian Indemnity* case until the recent Argentine default might have rejected its application *in casu* but has confirmed that necessity may be invoked in circumstances of extreme financial distress. If these jurisprudential findings are of any practical significance, then an effective interpretation of the conditions of article 25 ASRIWA is one that makes the necessity plea operable in the context of financial crises. Hence, it has been suggested that flexible standards of review originated from public law adjudication are pertinent in ascertaining whether the conditions of necessity have been satisfied. This is also consistent with the view that adjudicatory bodies should exercise judicial restrain when are called to assess issues of national economic management.

Nevertheless, from a policy perspective, necessity is a rather incomplete tool in dealing with sovereign insolvency. As it has been succinctly noted, necessity could merely function as a rescheduling of the sovereign's obligations,[208] whereas what will be likely needed to restore solvency will be drastic debt reduction. Even if successful, a necessity defense could not possibly perform this task. This means that a state of necessity could not be the alternative to a timely and thorough debt restructuring.

As a practical matter, international law remains surprisingly underdeveloped in the field of sovereign insolvency. International investment agreements may offer promising causes of actions to creditors, but up until today liability on that ground remains, by and large, unchartered territory. As far as there is no significant progress towards the development of primary rules

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[207] This has been confirmed in international jurisprudence on various occasions: *Gabcikovo-Nagymaros Project* paras. 47, 101, *Rainbow Warrior (New Zealand/France),* XX UNRIAA (1990), 217 at para. 75, *Socobelge* (*See* Ago Report at para. 30.)

[208] Michael Waibel *Two Worlds of Necessity* at 641-42.

regarding state responsibility in cases of sovereign insolvency, the defense of necessity will remain dormant. In the context of international investment arbitration, non precluded measures clauses contained in a number of international investment agreements will be able to prevent the host state's responsibility in situations of economic emergency. In these situations the general international law plea of necessity is likely to be redundant, as NPM clauses should be interpreted as presenting a lower threshold of satisfaction. Be that as it may, the necessity plea remains a residual defense that can acquire significance in the realm of sovereign insolvency adjudication. In cases of extreme financial difficulties, states can and should be allowed to seek recourse to it.