HOLDING SOVEREIGNTY RANSOM: THE GERMAN CONSTITUTIONAL COURT AND A SOVEREIGN'S INABILITY TO ACT DURING FINANCIAL CRISES

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Introduction

Sovereign debt has become a central institution of public finance. In 2001, the same year that Argentina defaulted on USD $100 billion of privately held debt, Niall Ferguson wrote:[1]

> [A] long-run view of public debt reveals that an apparently large "mountain" of debt may be far from disadvantageous, provided the institutions of a country's financial system are equal to the task of its management.

Sovereign institutions, however, are too often not equal to the task. In fact, sovereigns frequently borrow more money than they can service. Finance is an alluring concept; it allows governments to access substantial amounts of capital that can be crucial to securing higher standards of living within a national economy. The "small" cost is a period of temporary indebtedness. But when sovereigns become overburdened by the costs of servicing that debt, they will find that a painful restructuring is unavoidable. Suffice to say, borrowing money can become a "hideous addiction", even for sovereigns.[2]

For sovereigns on the edge of default, the crippling weight of their external debt will force a difficult question between the servicing of its debt and the need to maintain a range of essential public functions. The Argentine Republic, for instance, defaulted on its external debt in 2001 and then undertook a number of debt restructurings, aiming to restore its debt obligations to manageable levels. Of most interest to the field of international law, however, are the Republic's attempts to argue that the international law defence of necessity excused the non-fulfilment of its debt obligations.

The shift away from the use of lending from banks and foreign states in favour of the direct issuance of sovereign bonds to individuals also represents a "new complexity"[3] in the context of sovereign debt litigation, one which has implications in the application of international law. That is, in light of

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1 Niall Ferguson *The Case Nexus: Money and Power in the Modern World, 1700-2000* (Basic Books, New York, 2001) at 105.

2 Lee C Buchheit "Sovereign Debt in the Light of Eternity" in Rosa M Lastra and Lee Buchheit (eds) *Sovereign Debt Management* (Oxford University Press, New York, 2014) 463 at [28.15].

3 Beate Rudolf and Nina Hufken "Joined Case Nos 2 BvM 1-503 & 2 BvM 1-206" (2007) 101 AJIL 857 at 861.

the frequent waivers of sovereign immunity contained in sovereign bonds, the holders of defaulted bonds are able to sue sovereigns before a number of municipal courts. Because of this, domestic courts are presented with abundant opportunities to expound their own rulings on the application of sovereign emergency action regimes in the context of sovereign debt management.

In other words, the interplay between private commercial law actions in municipal courts and the principles of public international law has become ever more significant.[4] It is this dynamic that will be the examined in this article. In particular, this article will focus on one particular decision in 2007, in which the Federal Constitutional Court of Germany held that no "discernible general rule of public intentional law" enabled Argentina to plead necessity and suspend the performance of payment obligations due to private bondholders.[5] The decision sits alongside similar cases from municipal courts and international tribunals that have held sovereigns in default to their debt obligations. Like many other decisions regarding the Argentine crisis, a municipal court again gave short shrift to a sovereign's emergency regulatory capacity. However, the case was unique in that it denied the defence of necessity against private creditors. I contend that this outcome thoroughly undermines a sovereign's ability to act in the interests of its citizens during financial emergencies.

As a matter of constitutional propriety, municipal courts must give greater latitude to the plea of necessity in times of financial emergency. In Argentina's case, the debt crisis was accompanied with social turmoil and political strife – circumstances wherein a sovereign may well be required to prioritise the provision of basic public goods over the performance of its contractual obligations. First, municipal courts should respect this as a matter of sovereign principle. A failure to do so results in the ignorance of a crucial stakeholder in sovereign debt restructuring – the public. Second, domestic courts are ill-equipped to adjudicate on issues of economic necessity. I contend that their involvement simply leads to a fragmented, contradictory, and above all, weak patchwork of protection for States undertaking emergency financial regulation. Third, the framework of necessity at international law is itself inappropriate for the adjudication of sovereign debt and economic necessity. Rather, a "rebalancing", so to speak, in the treatment of the necessity test by domestic courts is needed.

4 See for instance Rudolf and Hufken, above n 3, at 861. Note, however, that the litigation of sovereign bonds is increasingly seen before international tribunals. A trio of recent cases now await their merits stages: see generally *Abaclat v Argentina (Jurisdiction and Admissibility)* ICSID ARB/07/5, 4 August 2011.

5 Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court] 8 May 2007, *Joined Case Nos 2 BvM 1-5/03 & 2 BvM 1-2/06* (Germany), (2007) 60 Neue Juristische Wochenschrift 2610. The translation used for the writing of this article can be found on the BVerfG website: <www.bundesverfassungsgericht.de/en>. All paragraph references are to the paragraphs outlined in that version.

Simply put, this article contends that municipal courts must move away from a legalistic understanding of states' emergency action. In doing so, municipal courts must give greater weight to the interests of the various stakeholders attached to a sovereign in default. This argument will be presented in four parts. Part I is introductory. It will provide an overview of the mechanics of modern public debt, the Argentine crisis in 2001 and the concept of necessity. Part II turns to consider the Constitutional Court's decision. Against the background provided in Part II, I will advance a critique of the Constitutional Court's decision. Where Part II aims to engage the Court on its own reasoning, Part III will argue that a domestic court is the wrong forum altogether to hear a claim of necessity in the context of sovereign debt and the fragmentation effect of such judgments. Finally, Part IV concludes that the municipal courts' use of a necessity framework in customary international law is inappropriate when addressing instances of financial emergency. I aim to put forward the case for a more balanced approach in this section.

I. Bonds, Argentina and Necessity: An Overview

A. The Shift Towards Bonds

The practice of selling bonds directly to the public has existed for centuries, becoming widely adopted during the First World War.[6] In the 1990s, States began to access the global capital market directly en masse, issuing bonds to individual lenders across the globe.[7] Throughout the last three decades, the primary form of a country's external debt – that is, the total debt which is owed to foreign creditors – shifted from traditional "institutional" lending by foreign states and large commercial banks towards the direct issuance of sovereign bonds to individual creditors.[8]

When a sovereign issues bonds, it does so in almost the same way as a private corporation. The underlying transaction is the same; a debt instrument in the form of a promise to repay the principal at the end of the loan term alongside periodic interest payments in return for the initial loan sum.[9] Many sovereign bonds, however, will include a submission to the jurisdiction of a financial centre, usually New York or London. Often, they will waive sovereign immunity from suit. To this end, sovereign bonds have been called "garden-variety" debt and the sovereign is really acting as a commercial party at arm's length.[10]

6 Ferguson, above n 1, at 118.
7 Gene Frieda "Sovereign Debt Markets" in Rosa M Lastra and Lee Buchheit (eds) *Sovereign Debt Management* (Oxford University Press, New York, 2014) 287 at [20.11].
8 Michael Waibel "Opening Pandora's Box: Sovereign Bonds in International Arbitration" (2007) 101 AJIL 711 at 713.
9 Alastair Hudson *The Law of Finance* (Thomson Reuters, London, 2009) at [35-02].
10 As per Justice Scalia in *Republic of Argentina v Weltover* (1992) 504 US 607 (SC).

Unlike corporate debt, sovereign debt involves a number of political and legal concerns. For instance, investors may have concerns over an issuing state's political and legal stability, especially where an issuing state bears a history of political and economic turmoil. If the state issued debt in its own currency and governed by its own laws, then it would be possible for that state to avoid default by simply changing its own laws governing the debt issuance. To counter this, an issuing state can issue debt governed by foreign law, submitting to foreign jurisdiction and waiving immunity from suit. In theory, this allows the state to demonstrate its bona fide intent to repay the lender. Similarly, investors may also be concerned over the stability of a state's currency – the value of debt could be sharply reduced if the state was simply to print money in order to repay that debt. Thus another way of placating investor concerns is to issue debt in another currency, for example in US dollars. In theory, this would eliminate concerns over the fluctuation of a less recognised currency. Without these measures the cost of borrowing, particularly for developing countries, would be extremely high. However, these measures also mean that the issuing state is exposed to exchange rate risk and loses the ability to manipulate its money supply in order to meet its repayment obligations. For these reasons, foreign currency debt can put the issuing government under heavy pressure to manage its debt.

The majority of litigants over sovereign bonds, however, were not those who originally subscribed to the bonds issued at their original value. Rather, the litigation of modern sovereign debt arose from a secondary market for trading sovereign bonds that initially developed between the commercial banks.[11] Litigants are mostly vulture funds, firms who took advantage of "the attendant opportunities for arbitrage".[12] These funds purchased sovereign debt on the secondary market, trading at a substantially lower price than its original value. These bonds would usually be the debt of a country on the edge of default, which vulture funds purchased before suing for payment at the full face value of the bonds, utilising the lack of bankruptcy protection for sovereign states.[13]

B. The 2001 Argentine Crisis

As Ferguson wrote, a "mountain" of debt is not necessarily disadvantageous, provided that a sovereign's institutions are capable of managing it. But in order to service its debt, a sovereign often needs more borrowing to repay any maturing debt obligations. Its ability to borrow, however, can be interrupted by fluctuations in the world markets. If the market experiences a downturn, that downturn could compromise the ability of a sovereign to refinance and service its existing debt.[14] The cost of servicing maturing debt can become

11 See generally Philip J Power "Sovereign Debt: The Rise of the Secondary Market and its Implications for Future Restructurings" (1996) 64 Fordham L Rev 2701 at 2715-2719.

12 Jonathan I Blackman and Rahul Mukhi "The Evolution of Modern Sovereign Debt Litigation: Vultures, Alter Egos and Other Legal Fauna" (2010) 73 LCP 47 at 49.

13 At 49-50.

14 Buchheit, above n 2, at [28.17].

unbearable. If so, then sovereigns with unsustainable debt obligations face the risk of a default, alongside a lengthy restructuring process in the hope of restoring its debt to manageable levels.[15]

In 2001, the Argentine Republic experienced such a default. It was the largest default in history, as well as one of the most complex given the diverse structure of the Argentine public debt.[16] At the time of its default, the Republic owed around USD $120 billion in private debt, alongside an official bilateral and multilateral debt portfolio in excess of USD $30 billion. The Republic carried out three major restructurings in attempts to manage its debt concerns. It offered debt "swaps" in 2001, 2005 and 2010, exchanging existing bonds for new ones. These new bonds reduced the dollar value of the outstanding borrowed sum and extended the date at which the bonds would become due. In return, the Republic offered a higher interest rate to participating creditors.

Because a default sovereign has no bankruptcy protection like that of a private borrower, bondholder participation in a debt restructuring is voluntary. Creditors are not required by law to participate in a debt restructuring. Therefore in simple terms, the idea behind a sovereign debt restructuring is to present creditors with a proverbial carrot:[17] bondholders are offered a reduction on their original lending as opposed to the possibility of losing it all.

In reality, foreign holders of Argentine bonds were presented with the stick. Argentine bondholders were given a "take-it-or-leave-it" offer in the form of an abundantly clear threat: "eligible Securities that are not tendered may remain in default indefinitely."[18] It was a clear message that the bondholders who did not accept the exchange would not be paid. In effect, the Republic threatened a prolonged default unless bondholders subscribed to the restructuring. Essentially faced with coercive measures, around three quarters of Argentina's bondholders accepted the 2005 offer.[19] They took roughly 30 cents on the dollar in exchange for marginally higher interest rates. After the exchange, the Republic carried out its threat. It passed the Lock Law, which prohibited the payment to those who did not participate in the debt swap – the holdouts.[20] Without that law, the holdouts would receive the full payment of their old bonds and such could jeopardise the success of the swap.

The nature of the Republic's debt made it difficult to seek an effective legal solution to its restructuring. Argentina's debt system was made up of multiple individual bonds, converted from large amounts of bank loans.

15 Martin Wolf "Defend Argentina from the Vultures" (24 June 2014) Financial Times <www.ft.com>.

16 Arturo C Porzecanksi "From Rogue Creditors to Rogue Debtors: Implications of Argentina's Default (2005) 6 Chi J Intl L 311 at 317.

17 See generally Lee C Buchheit and Elena L Daly "Minimizing Holdout Creditors: Carrots" in Rosa M Lastra and Lee Buchheit (eds) *Sovereign Debt Management* (Oxford University Press, New York, 2014) 3.

18 Republic of Argentina Prospectus Supplement 10 January 2005, s 29.

19 See Wolf, above n 15.

20 See Georges Affaki "Revisiting the Pari Passu Clause" in Lee Buchheit and Rosa M Lastra *Sovereign Debt Management* (Oxford University Press, New York, 2014) 39 at 45-46.

Therefore, one "type" of borrowing was multiplied into many. As a result, when the 2005 debt restructuring took place, it involved more than 140 different types of sovereign bonds issued in six currencies, subject to at least eight municipal laws.[21] The holders of those instruments were not institutions with political gait, but rather made up of private individuals ranging from corporations, banks, all the way through to ordinary persons. The lenders were structurally weak, unable to form alliances and without any form of institutional representation at an international level, many of which would on-sell their bonds to vulture funds.[22] When the disgruntled holdouts sued for the payment of their bonds at face value, their claims were similarly spread across a number of jurisdictions. More than forty lawsuits were filed against Argentina in New York. Over one hundred claims were filed in Italy and Germany, alongside various investment treaty claims launched before arbitration tribunals.[23] The potential liability of the Republic could reach several dozen billion dollars.[24]

II. Necessity and the German Constitutional Court

In many of these disputes, the Republic argued that its emergency measures were necessitated as a response to its deep financial crisis. Argentina argued that its default and restructuring were necessary in order to stave off economic and social ruin, relying on the customary international law formulation of necessity before both municipal and international tribunals. Where available, the Republic also relied on non-precluded measure clauses under its international investment agreements.

The Federal Constitutional Court – the Bundesverfassungsgericht (BVerfG) – proceeding of 8 May 2007 was composed of a number of joint proceedings submitted by the Frankfurt am Main Local Court over a period of three years. It was one of the many cases where bondholders sought to recover the outstanding sums that the Republic had owed before discontinuing the service of its external debt. The Frankfurt am Main Local Court had submitted the question of "whether the state necessity declared by [Argentina] with respect to the inability to pay entitles [the Republic] by a force of a rule of international law to temporarily refuse to meet due payment claims".[25] Notably, the Court squarely addressed an issue that has been largely

21 Michael Waibel *Sovereign Defaults Before International Courts and Tribunals* (Cambridge University Press, Cambridge, 2011) at 15-16.

22 Jorn Axel Krammerer "Argentine Debt Crisis" (2011) *Max Planck Encyclopedia of Public International Law* <pil.ouplaw.com/home/EPIL>.

23 Federico Sturzenegger and Jeromin Zettelmeyer *Debt Defaults and Lessons from a Decade of Crises* (MIT Press, Cambridge, 2006) at 200-201.

24 Waibel *Sovereign Defaults*, above n 21, at 16-17.

25 BVerfG, above n 5, at [8].

neglected by investment arbitration tribunals and international courts.[26] That is, whether Argentina could invoke the general international law conception of necessity – as a defence arising in inter-State relationships – to excuse its breach of a *private law* contract entered into with *private individuals*.

The Constitutional Court recognised that the doctrine of necessity was "inherent in both the national legal orders and in international law."[27] Citing both ICJ and ITLOS cases, the Court accepted that art 25 of the ILC Articles on State Responsibility reflected customary international law.[28] As such, the Republic could not plead necessity unless the impugned act was the only means to safeguard an essential interest threatened by a grave and imminent peril, without seriously impairing an opposing essential interest.[29] It should be noted that necessity is narrowly defined, considering exceptional cases where States may alter their external legal obligations. A state cannot plead the defence if the international obligation excludes the defence or if the State has contributed to its own state of necessity.

However, the Court viewed Argentina's actions in the capacity of a private individual contracting with other private individuals. A seven-to-one majority rejected the notion that any general international law permitted a State to invoke necessity to suspend its payment obligations in relation to private individuals.[30] The majority came to this conclusion by dismissing the decisions of international courts and tribunals on the defence of necessity as inconclusive authorities.[31] Decisions of international courts, such as Serbian Loans and Venezuelan Railroads, were "alleged violations of the law of aliens".[32] Thus the majority deemed inter-State disputes to be irrelevant to the question of the interests of private persons and providing no basis for evaluating state practice in regards to necessity where a state contracts with private individuals.[33] The same approach was applied to investor-State disputes under the ICSID Convention. The majority of the Constitutional Court distinguished the Argentine utilities cases because the investor alleged violations of protection standards in bilateral investment treaties (BITs).[34] The

26 Stephan W Schill and Yun-I Kim "Sovereign bonds in economic crisis: Is the necessity defense under international law applicable to investor-State relations? A critical analysis of the decision by the German Constitutional Court in the Argentine bondholder cases" in Karl P Sauvant (ed) *Yearbook on International Investment Law & Policy 2010-2011* (Oxford University Press, New York, 2012) 489 at 491.

27 BVerfG, above n 5, at [37].

28 The Court referred to *Gabciokovo-Nagymaros Project (Hungary v Slovakia) (Merits)* [1997] ICJ Rep 7; and *Construction of a Wall in the Occupied Palestinian Territory* (*Advisory Opinion*) [2004] ICJ Rep 136. The Court also cited the ITLOS decision *M/V "SAIGA" Case (Saint Vincent and the Grenadines v Guinea)* ITLOS Reports 1997.

29 James Crawford *The International Law Commission's Articles on State Responsibility: Introduction, Text and Commentaries* (Cambridge University Press, Cambridge, 2002) at 178.

30 BVerfG, above n 5, at [28]-[30].

31 Schill and Kim, above n 26, at 496; and BVerfG, above n 5, at 59.

32 Rudolf and Hufken, above n 3, at 858.

33 BVerfG, above n 5, at [60].

34 At [53]-[57].

majority considered that rights under a BIT were ultimately owed to other state parties – they were not claims under private law, despite the fact that investors are private persons.

Having distinguished decisions of international courts and tribunals, the majority turned to domestic decisions in its search for evidence of state practice. Instead of finding a general pattern of behaviour, the majority found "significant differences in the way that municipal courts dealt with the defence of necessity in connection with a state's inability to perform its private law obligations".[35] The majority found that the courts had either "discussed [the] factual basis for the claim of necessity without attending to the legal prerequisites of the defence under public international law, or they evaded the question altogether by pointing to state immunity."[36] With no uniform approach to a State's inability to pay as excusing service of sovereign debt, the majority deemed that necessity did not constitute a general principle of law equally existing in State relations with private individuals as it did in inter-state relations.

The following sections discuss the debate between the majority and the minority regarding whether necessity exists as a general principle of law across domestic law. It also outlines the implications of the majority's approach on a state's sovereign capacities. The next two sections are underpinned by a unifying argument: that states must be allowed the ability to modify contractual obligations in the interests of its public. For this reason, this article asserts that the minority argument is preferable from a constitutional point of view.

A. State Practice

The dissent by Justice Lubbe-Wolff argued strongly that necessity constituted a general principle of law irrespective of the legal nature of the creditor. In her view, there was no reason why necessity should be confined to inter-state or investor-State relations. In other words, there was no reason why a debtor state's protection against other states should be different to its protection against foreign private creditors.[37]

There are two ways of countering the majority's ruling. The first is Justice Lubbe-Wolff's position, arguing that ICSID proceedings did not point to a distinction between interstate relations and proceedings between State and an individual creditor.[38] Rather, the application of the doctrine in those investment arbitrations itself point to the availability of the doctrine in disputes between states and individuals.[39] With due respect, while I agree with the final position, I believe that the minority's argument on this point is not necessarily correct. Justice Lubbe-Wolff's position is premised on

35 Rudolf and Hufken, above n 3, at 859.
36 At 859.
37 BVerfG, above n 5, at [86].
38 At [76]-[79].
39 Rudolf and Hufken, above n 3, at 860.

the fact that there is no logical distinction between investors and private individuals. While investors are private individuals, Andrea Bjorklund points out that private investors are essentially third-parties who benefit from investment treaties. The rights of these third parties are limited to what the contracting States confers upon them. Therefore, the investment agreement is the primary source of their rights. Under this reasoning, investor-State disputes, governed by a treaty framework, are different to disputes involving private individuals.

A stronger argument would be to say that the distinction does not matter – it is inappropriate to differentiate between legal spheres.[40] It is largely immaterial who the state invokes the defence against. This is because the primary basis of necessity is the essential interest of the State under threat. Where a State invokes necessity as a public international law rule in domestic courts, the State is "actually asserting an entitlement that stems from public international law vis-à-vis the organs of that state."[41] As Herdegen argues, a necessity defence protects essential functions of a State in relation to the international community at large.[42] This is the fundamental point that a court must respect. It would be inconsistent for States to be protected by necessity against other States and private investors and yet be exposed to private claims before domestic courts. The lack of a necessity defence here would threaten to cut across successful claims of necessity in investor-State and inter-State disputes.

Thus the second and more powerful critique of the majority's findings is to show its conflict with the rationale underpinning the rule of necessity. Justice Lubbe-Wolff makes this observation in her judgment. The further argument advanced by this article is this: sovereigns have and will always face emergencies in one form or another. Thinking of "emergency" in Gross and Ni Aolainn's conception as "aberrations to the otherwise ordinary state of affairs", it is natural that states will call for derogation from normal legal rules during some instances of exigency.[43] A claim of necessity, then, must be understood as an expression of sovereignty "within the rubric of international legality", bearing in mind that a State's assertion of necessity carries with it a *political* dimension in addition to a *legal* one.[44] Here, the exercise of necessity *politically* should be understood as the action of a state that serves its own interest, in direct or indirect contravention of an existing legal obligation. Therefore this view of necessity, according to Desierto, is that States assert a kind of political authority and act outside ordinary legal rules. In these instances, necessity appears "as an

40 See BVerfG, above n 5, at [89].
41 Rudolf and Hufken, above n 3, at 860.
42 Matthias Herdegen *Principles of International Economic Law* (Oxford University Press, Oxford, 2013) at 471.
43 Oren Gross and Fionnuala Ni Aoullon *Law in Times of Crisis: Emergency Powers in Theory and Practice* (Cambridge University Press, New York, 2006) at 2.
44 Diane A Desierto *Necessity and National Emergency Clauses: Sovereignty in Modern Treaty Interpretation* (Koninklijke Brill NV, Leiden, 2012) at 3.

extra-legal *political* prescription."[45] Indeed, State practice often oscillates around this idea, constructed upon the most basic understanding of necessity: States may act and undertake emergency actions for self-preservation. This core idea has coalesced into the doctrine of necessity.[46]

Generally speaking, State practice and the jurisprudence of international courts and tribunals accept that States maintain a reserve power to modify and or terminate contracts with private individuals for public interest.[47] This idea is broader than the understanding of "necessity" that is entrenched in art 25 of the ILC Articles on State Responsibility. In international law, a State may be granted some leeway where it faces a decision between a contractual obligation and public interest.[48] It may be that the decision to prioritise public interest over its contractual obligations goes to the very idea of self-preservation itself.

For instance, in *Oliva*, the expulsion of an investor was deemed justifiable because the investor was suspected to have cooperated with revolutionary factions.[49] Even more directly, the Iran-United States Claims Tribunal in *International Finance Corp v Iran* said: "in no system of law are private interests permitted to prevail over duly established public interest, making impossible actions required for the public good."[50] Similarly, a sovereign's power to alter a contractual obligation with private individuals has also been accepted by the ECtHR in relation to a State's failure to pay on its government bonds. The Court in *Malysh v Russia* recognised that Russia's failure to pay its internal bonds due to a financial crisis was excusable on the grounds that it defined its "budgetary priorities in terms of favouring expenditure on pressing social issues".[51] In these cases, it is important to note that while a nation may possess the power to break an obligation, it is still obliged to pay due compensation.[52]

Therefore, the plea essentially involves antagonism between an essential interest and the obligation of a State invoking necessity. If the plea seeks to protect a State's essential interests, then at a fundamental level, it remains true that the defence of necessity can be described as the manifestation of the idea of self-preservation in general international law.[53] In this way, it is submitted that the defence of necessity can be seen to be a largely *internal* one, where the foremost concern is self-preservation of the State in crisis, save for instances where this is outweighed by an opposing interest of another State or individual.

45 At 2.
46 *Gabcikovo-Nagymaros*, above n 28.
47 Schill and Kim, above n 26, at 505-506.
48 At 506.
49 *Oliva Case* (Italian-Venezuelan Commission) (1903) 10 RIAA 600.
50 *Amoco International Corp v Iran* (1987) 15 Iran-US Claims Tribunal Rep 189 at 178.
51 *Malysh and Others v Russia* (*Judgment*) Application No 30280/03, Section 80 ECtHR,11 February 2010 at 80. Note however that the Russian argument failed on another ground because it failed to meet the high burden of proof in the ECtHR.
52 *Oliva,* above n 49, at 609.
53 *Gabciokovo-Nagymaros*, above n 28, at 51.

B. Sovereignty

The minority contends that its line of argument draws support from international human rights law. However, because the majority found no general principle of law could exist across the relationship between international and domestic law, it did not consider the effects or limits of a necessity plea. In other words, the majority effectively ruled that a sovereign's contractual obligations were prior to any obligations that it had to its public without assessing the implications of doing so. First, in terms of commercial realities, the requirement for a State to pay its bondholders out in full jeopardises the ability of a State to undertake any restructuring whatsoever. As discussed above, the carrot presented to bondholders is that they will recoup *some* of their original lending from a bond swap. If a State is forced to pay holdout bondholders in full, then there is no incentive of any kind for any bondholders to participate in a restructuring. Without the ability to restructure debt effectively, States are condemned to perpetual default, or at the very least, to take their chances sourcing finance from extra-national organisations and foreign states. By extension, the sovereignty of a state to make its own internal decision is compromised.

Secondly, from a legal point of view, the principle established in *Malysh, Oliva* and *International Finance Corp* is still valid. Despite the peculiar features of sovereign bonds, such as States acting as private borrowers and submitting to the law of a foreign state, States must be able to alter contractual obligations in order to protect a "public interest of paramount importance."[54] After all, states issuing debt in good faith often do so for reasons that are not commercial.[55] The capital derived from issuing bonds may be used to provide essential public services. Therefore, it must be recognised that where a State declares a default on its external debt, it can be seen as a "protection of values that are of concern" to the State.[56] The State has consciously placed the need to discharge its duty to its citizens over the payment of debt obligations. If the core value of necessity lies in a State's need to preserve itself, necessity must be recognised to include a political decision making factor where a State expresses its sovereignty in the form of a foreign policy decision. The word "political" is used here in the sense that the State actively makes a choice out of numerous alternatives to act in the best interests of its *res publica*. The idea of self-preservation and indispensable interests logically extends to protection of a State where it seeks to fulfil its sovereign obligations to its citizens.

54 Schill and Kim, above n 26, at 508. Similar United States rulings currently form the bases of an application to the ICJ, where Argentina argues that American court rulings have curtailed its ability to act as a sovereign. See Ken Parks "Argentina Sues US in International Court of Justice over Debt Dispute" (7 August 2014) Wall Street Journal <www.wsj.com>.

55 Blackman and Mukhi, above n 12, at 52.

56 This line of thought owes much to Sornarajah's discourse on the protection of sovereignty under investment agreements. See M Sornarajah *The International Law on Foreign Investment* (3rd ed, Cambridge University Press, 2010) at 225.

During a financial emergency, it is crucial for a State to maintain regulatory capacity to provide essential public goods to its citizens. A sovereign faces important rights claims from its citizens: the provision of food and clean water, housing, healthcare and the opportunity to make a living are few of the many examples.[57] These rights are protected by the Argentine Constitution and by a vast patchwork of international treaties – including the Universal Declaration of Human Rights.[58] The provision of such public goods, as above, may require the State to prioritise such public duties over its external contractual obligations. This notion of crucial public goods is one that seems to be accepted in political theory. For instance, one may say that "[n]o government is legitimate that does not show equal concern for the fate of all those citizens over whom it claims dominion and from whom it claims allegiance."[59] More directly, a Hobbesian would argue that citizens enter into society for the security and personal well-being that a State may provide.[60] As such, a State's protective function, namely its responsibility to ensure the security of its citizens, is the foundation for its legitimacy.[61] To this end, a State's failure to provide essential public goods can be likened to an abdication of its protective function, and by extension, an abdication of its legitimacy. After all, a State should not be expected to disband its police force and submit to chaos in order to meet the claims of its moneylenders.[62] This was accepted in Lubbe-Wolff's dissent, which recognised that the enforcement of payment obligations would cause, aggravate or prolong a State's inability to discharge basic obligations to its citizens.[63]

For Argentina, a default was a fundamental "choice" between fulfilling social obligations to its people or fulfilling contractual obligations to holdout creditors and sacrificing a high percentage of its GDP in order to do so.[64] Indeed, Argentina faced unprecedented poverty during its crisis. It was consumed by riots and experienced a dramatic escalation in both unemployment and poverty. Moreover, the Republic faced a very real possibility of the systemic collapse of its social sector.[65] The Republic's healthcare system, for one, violently teetered on the edge of collapse. The burden of debt alone has been found by the UN Commission on Human Rights to be a "critical factor adversely affecting economic, social and living standards in many

57 Sabine Michalowski *Unconstitutional Regimes and the Validity of Sovereign Debt: A Legal Perspective* (Ashgate, England, 2007) at 28.
58 At 28.
59 See Ronald Dworkin *Sovereign Virtue: the Theory and Practice of Equality* (Harvard University Press, Cambridge, 2000).
60 Thomas Hobbes *Leviathan* (Broadview Press, Peterborough, 2002) at ch 16.
61 At 166.
62 See BVerfG, above n 5, at [69].
63 At [87].
64 Michalowski, above n 57, at 28.
65 At 29.

developing countries, with serious effects of a social nature."[66] A situation where sovereigns are forced to continue payment to creditors at rates that it cannot afford after a crisis would be even worse. To continue debt servicing meant displacing payments dedicated "to [the] development and the creation of genuine and not only precarious employment; health; education; and security."[67] In announcing a moratorium on servicing its debt, the State made a conscious foreign policy decision that the demand of holdout creditors for a sovereign to pay at rates that it cannot bear would only result in "increasing and deepening poverty".[68] The plea of necessity is therefore utilised as part of a State's need to enact regulatory powers "essential to the promotion of the basic needs of its citizens."[69]

Viewing necessity from within a strict legal framework fails to acknowledge the above. The effect of the Constitutional Court's majority decision is to bar States from choosing a solution to its crisis that it preferred. In effect, states are forced to pursue one particular solution to economic crises. Similarly, the scope of governmental emergency action was particularly limited in two of the utilities cases, *Sempra* and *Enron*.[70] Both tribunals refused to allow Argentina to make its own decision as to how to protect itself – finding it unnecessary to consider the "comparative benefits of alternative measures".[71] The rulings are tantamount to preventing a State from acting in the best interests of its citizens, save for instances of an absolute collapse in economic and social order. This would defeat the entire purpose of having a defence of necessity. It is wholly inappropriate for judges to limit a sovereign State to a single course of action in order to satisfy the requirements of necessity and effectively take the protection of citizens away from the State's decision-making authority.

III. The Legal "Space" of Domestic Courts

The limitation of a sovereign's ability to act in the best interests of its citizens – presented in Part II – is only one problem demonstrated by the BVerfG decision.

In my view, the minority reached a more commercially and theoretically defensible position. It rejected the majority's ruling that a lack of uniformity in municipal court decisions precluded a necessity plea in relation to a State's

66 UN Commission on Human Rights *Effects of the Full Enjoyment of Human Rights of the Economic Adjustment Policies Arising from Foreign Debt and, in particular, on the Implementation of the Declaration on the Right to Development* Res/199/22 (1999).

67 Michalowski, above n 57, at 30.

68 At 31.

69 See Valentina Vadi *Public Health in International Investment Law and Arbitration* (Routledge, Oxon, 2013) at 50-51.

70 Antoine Martin "Investment Disputes after Argentina's Economic Crisis: interpreting BIT Non-precluded Measures and the Doctrine of Necessity under Customary International Law" (2012) 29 Journal of International Arbitration 52 at 66.

71 At 66.

non-performance of private law obligations.[72] Instead, Justice Lubbe-Wolff found the existence of a recognised principle that national courts accepted as the right of a foreign State to take measures to terminate the state of emergency, despite the absence of a general rule of necessity. This position recognises the need for States to maintain regulatory space to maximise the interests of its citizens.

However, the minority judgment also unearths an underlying issue. Municipal courts have largely treated cases of financial necessity in relation to sovereign debt with a narrow jurisprudential lens. They have tended towards a private law outcome despite the sovereign being very much a public international law actor. Moreover, the litigation of sovereign debt before different domestic courts allows each court to put forward their own interpretation of international law principles, namely the state protection for emergency action. This creates a vast and inefficient patchwork of State protection. Needless to say, it makes the search for a uniform principle of necessity impossible. Additionally, it also contributes to a fragmented system and undermines the protection for bankrupt States as a whole. As such, this section puts forward the argument that domestic courts are ill-equipped fora to rule on issues of necessity in the context of sovereign debt.

A. The [Im]Propriety of Domestic Court Adjudication

When municipal courts adjudicate on issues of sovereign debt, they invariably hear issues involving sovereigns. A sovereign's identity also includes a multitude of stakeholders – the most important of which are its citizens – that are directly attached to a ruling on the sovereign's contractual obligation. However, domestic courts are quick to overlook such considerations, and rule based on contractarian principles. Domestic courts, in sum, are likely to reduce sovereign bonds to a single contractual dimension.

One can interpret this to mean that a sovereign bond has a dual nature. After all, one commentator has written that sovereign debt sits in a "conceptual space on the border between law and politics: between the realms of enforceable legal rights and anarchic realpolitik".[73] First, it consists of contractual obligations: the sovereign – as borrower – must repay the amount of money denoted by the bond. It must pay the interest specified and follow the terms of the debt instrument. It can be sued for non-payment like a private individual, before a court in New York, London or Germany. But more importantly, a sovereign bond also has obligations that are different to a private borrower. These obligations are by the virtue of the borrower's identity as a *sovereign.* Its stakeholders are not profit-driven shareholders like private corporations, but citizens who are dependent upon services provided by its state. These citizens are the first persons affected when a state's financial

72 BVerfG, above n 5, at [92]-[93].

73 W Mark, C Weidemaier and Ryan McCarl "Creditors' Remedies" in Rosa M Lastra and Lee Buchheit (eds) *Sovereign Debt Management* (Oxford University Press, New York, 2014) 139 at 147.

incapacity jeopardises its ability to sustain essential services, like the collapse of the Argentine public health care system. According to Justice Lubbe-Wolff, the obligations to maintain such services for its people form *jus cogens* norms. Few would disagree on this point. Thus, returning to Weidemaier's statement, the "anarchic realpolitik" can consist of instances where States are forced to act in their own interests (or that of their people) in derogating from strictly commercial obligations. In these instances, the sovereign might neither obey its contractual obligations nor act within a specified legal framework like necessity.

However, municipal courts have firmly tacked towards the first conception of sovereign debt above. This is because the adjudication of sovereign debt often occurs within a legalistic framework, as is shown by the Constitutional Court decision. Instead of an abstract idea of serving a State's own interests for the sake of self preservation, adjudication by municipal courts treats a State's emergency regulations as arising from within a formal and "doctrinal" rendering of necessity.[74] It is decided on the basis of a sequence of legal tests: for instance in art 25 of the ILC Articles on State Responsibility. The BVerfG decision – alongside many other cases denying the application of necessity – demonstrates this narrow jurisprudential view of national courts. Municipal courts are quick to recognise the contractual nature of bonds and hurriedly point to the sovereign's obligations under private law.[75] The jurisprudence of these financial centres thus "strongly favours the enforcement of financial contracts according to their terms."[76] Bonds submit to municipal jurisdiction and waive immunity by the terms of their contract, which helps to accelerate legal enforcement. Consequently, holdout creditors are most likely to sue in municipal courts for the repayment of their bonds. This becomes problematic for defaulting sovereigns. For bankrupt sovereigns, the submission to the jurisdiction of a judge in New York has been compared to a mother dropping her child off at a day care centre run by King Herod.[77]

The problem, as Buchheit points out, is that the limit of a court's jurisdiction is to utter the word "pay".[78] The extent of a domestic court decision is to compel a sovereign to perform its payment obligations. When the United States Supreme Court in *Weltover* unanimously reduced the functions of sovereign debt fundraising to that of a "private player", one could observe that this is a *commercial law*-driven approach.[79] Applying commercial jurisprudence, the Court allocated obligations and rights when business relations collapse, interpreting financial contracts according to their terms.[80]

74 See for instance Diane Desierto's conception of a "spectrum" of necessity in Desierto, above n 44, at XIII-XX.

75 Mark, Weidemider and McCarl, above n 73, at 147.

76 Lee C Buchheit "Negotiating the submission to jurisdiction clause" (1993) 12 IFLR 27 at 27.

77 Lee C Buchheit *How to Negotiate Eurocurrency Loan Agreements* (2nd ed, Euromoney, London, 2006) at 134.

78 Buchheit "Sovereign Debt in Light of Eternity", above n 2, at [28.12].

79 *Weltover,* above n 10.

80 Mark, Weidemaier and McCarl, above n 73, at 147.

It could be said that Argentina, in waiving its sovereign immunity, accepted such treatment in return for an lower interest rate than what it would have had to pay without a waiver. But sovereign bonds bear elements of the inverse – bonds are akin to private-private contracts only during the course of normal business relations. Upon a default, domestic courts cannot possibly prescribe *how* that sovereign is to structure the payment. They cannot describe the nature of the sacrifices that the sovereign must impose in order to satisfy the judgment. The problem when a municipal judge rules that the sovereign must pay out in full to holdouts is that it effectively allocates the discomfort that is to be felt among the citizens of a foreign State (who bear the most harm through imposed austerity measures), the other classes of creditors (who lose out on their bargain) and the foreign taxpayers that would fund a potential bailout.[81]

Moreover, because a sovereign often has a variety of mechanisms to prolong the battle of default – such as borrowing from the IMF, austerity measures or changing its taxation structure – a default can be seen as an active decision, a statement of foreign policy itself. The decision itself might be an active recognition of the need to maintain essential duties to its people. No sovereign engages its debt with an intention to default. Therefore, when a state has made the decision to default, it can be seen as a conscious decision that it can no longer service its debt without allocating further discomfort to its citizens or without the possibility of external bailouts. This is in contrast with a private borrower, who defaults when it no longer has the ability to refinance or meet its obligations. Where a sovereign makes an active decision at a particular point in time to default, it has made a choice as to what it perceives as the best way to allocate the costs on its citizens and third parties. By requiring strict enforcement of the bonds at full face value, the domestic judge takes away this ability for a state to allocate loss. Instead, the debtor state is forced to pay everyone. In essence, the domestic judge reduces a complex foreign policy decision to the mere interpretation of a loan contract.

Thus, to reach decisions like that of the Constitutional Court, domestic courts seek the best of both worlds, so to speak. They apply the legal fiction of equivalence between a sovereign and a private borrower by interpreting the contract strictly according to its terms.[82] *Weltover,* for instance, held that the uncommercial purposes for a sovereign issuing debt are irrelevant.[83] Domestic courts will disregard the function of sovereigns in making a deliberate foreign policy or economic policy decision in its default, one that could well be linked to its sovereign duty to provide essential public services to its citizens. Then, the domestic courts will also pay no heed to the Sovereign's necessity and state immunity protection, which developed

81 At 147.

82 See Bucchheit "Sovereign Debt in light of eternity", above n 2.

83 *Republic of Argentina v Weltover* (1992) 504 US 607; and Blackman and Mukhi, above n 12, at 52.

to mirror a rough form of the bankruptcy protection enjoyed by private borrowers.[84] Therefore sovereign borrowers are both similar and dissimilar to private borrowers *at the same time*. It is flawed reasoning to first liken a sovereign to a private borrower, but then apply the law as if it were not. This has the cumulative effect of restricting the foreign policy and sovereign decision making of a state and limiting its ability to choose the best alternative for its citizens.

B. Fragments of State Protection

The nature of necessity has been called "ubiquitous".[85] It exists across history and addresses multiple forms of exigency and exists across most jurisdictions in some form. Some jurisdictions may rule differently on the contents of necessity as a general principle of law. In others, the issue manifests under disputes relating to the doctrines of immunity, comity or under "non-precluded measure" clauses in investment treaties. In many cases, the outcome is the same. As is canvased above, it is based on a common core idea: that states must act to preserve an underlying interest. However, the wide proliferation of ways in which different courts have treated the idea undermines the effectiveness of the defence and leads to instances where a myopic review of international jurisprudence will conclude that no defence exists. This section revolves around the reality that each country will interpret legal rules differently and the fragmentation that occurs as a result.

In many municipal systems, general legal principles provide for the modification of contractual obligations in times of exigency.[86] The problem, however, is that "international law differs depending on the State or region in question."[87] According to Pauwelyn, the "geographical" fragmentation of international law can exist because there are as many law-makers as there are subjects of international law.[88] Thus, international law is ensured to be diverse "both in substance and procedure".[89] Because sovereign bonds submit to the jurisdiction of domestic courts, each jurisdiction in which claims are pursued is able to put forth its own interpretation of the matter. Domestic courts exist within the political space of a sovereign state.[90] Each court's decisions are articulated within its own political space – namely due to its existence as an organ of the relevant State – leading to the creation of

84 See Blackman and Mukhi, above n 12.
85 See Desierto, above n 44, at 63-116.
86 See generally Desierto, above n 44, at 1-18.
87 Joost Pauwelyn "Fragmentation of International Law" (2006) *Max Planck Encyclopaedia of Public International Law* <pil.ouplaw.com/home/EPIL>.
88 Pauwelyn, above n 87.
89 Pauwelyn, above n 87.
90 To this end, Jan Paulsson argues that domestic courts should be seen as manifestations of the State; no more, no less. See Jan Paulsson *Denial of Justice in International Law* (Cambridge University Press, Cambridge, 2005) at 84.

many distinguishable and entrenched interpretations of emergency action.[91] In this way, national courts create radically different "hybrid international and national norms".[92]

For instance, while the Constitutional Court analysed the issue of Argentina's emergency regulation under the doctrine of necessity, it is only one strand in a patchwork made up of different defences. The issue is largely litigated in American courts under the doctrines of act of state, political question and subsequently sovereign immunity.[93] The English courts, by contrast, often dealt with the issue under the doctrine of justiciability.[94] All of these approaches can be seen as responses to sovereign emergency actions that coalesce into different "constitutional" doctrines of emergency action. Not all of these approaches fall under one umbrella. However, they all provide protection for a similar idea. Indeed, the rationale for the protection of sovereign immunity, for instance, is that states should not be subject to the "disruption and *political ramifications* that occur" in bringing a sovereign before municipal courts.[95]

Therefore decisions on emergency action, whether manifested through necessity or immunity, are ultimately the result of a country's "constitutional dialogue" on states' emergency action.[96] Indeed, the Federal Constitutional Court's majority judgment could be interpreted this way. As Roberts argues, each domestic "dialogue" is then surveyed "as evidence of the existence and content of international law.[97] But if each State puts forward their own form of emergency action regulation, the logical conclusion is that a uniform application of necessity from domestic regimes does not exist. That is, a court would be unable to draw together each individual formulation of emergency action to find a unified theory or approach. It would therefore follow for the Court to find that "domestic courts in various countries did not follow a uniform approach in treating a State's inability to pay as an excuse for severing its sovereign debt".[98]

The result is fragmentation: the protection for a state's emergency regulatory action is governed by a "proliferation of substantive international law rules".[99] However, there is no effective mechanism in international law that establishes a hierarchy, or mitigates conflicts between different

91 Desierto, above n 44, at 36.
92 Anthea Roberts "Comparative International Law? The Role of National Courts in Creating and Enforcing International Law (2011) 60 ICLQ 57 at 58.
93 *Republic of Argentina v NML Capital Ltd* 189 L Ed 2d 234 US (2014).
94 For instance, see *Kuwait Airways Co v Iraqi Airways Co* (Nos 4 and 5) [2002] 2 AC 883 (HL).
95 Blackman and Mukhi, above n 12, at 47-48.
96 Desierto, above n 44, at 35-36.
97 Roberts, above n 92, at 60.
98 Stephan W Schill "German Constitutional Courts Rules on Necessity in Argentine Bondholder Case" (31 July 2007) American Society of International Law <www.asil.org>.
99 Sabine Schlemmer-Schulte "Fragmentation of International Law: The Case of International Finance & Investment Law Versus Human Rights Law" (2012) 25 Global Business & Development Law Journal 409 at 417.

international law rules. International law has never provided a "clear-cut" response to sovereign debt, with a lack of guiding principles as to when a sovereign will be able to derogate from its international sovereign bond obligations.[100] Where the subject matter straddles the realms of both international law and domestic commercial law, the problem is exacerbated. In such cases, Waibel argues that recourse to municipal law will provide "more nuanced answers."[101] This represents the fact that international law itself has been argued to be a system of meaningful interrelationships between a collection of norms – including the discourse of municipal courts.[102] That is, the structure of international law is an interwoven connection of "substantive norms" that cannot be pulled apart without unravelling the system.[103] In this system, municipal and international conceptions of necessity do not exist in separate spheres. They exist as "configurative interactions involving semantics and methodology."[104] But this is problematic because fragmentation of the necessity defence across many dimensions renders collective interpretations of emergency action difficult. That is, normative interpretations of necessity are made impossible because of the lack of consistency across the application of emergency action doctrines.[105]

Fragmentation is not inherently negative. Bjorklund points to instances where fragmentation can be beneficial, playing a role in creating highly specialised decision-makers.[106] Similarly, Charney has suggested that existence of multiple tribunals will eventually strengthen the rule of international law.[107] Lastly, Koskenniemi suggests that all adjudication is good – the struggle for coherence in international law is a "hegemonic" project, seeking the dominance of one particular institution.[108] But, municipal court judgments on financial necessity are not instances where the adjudicators are particularly specialised and issue judgments on one particular area only. And in response to Koskenniemi, it is fruitless to point to the downsides of coherence when assessing the present problem. In an interconnected world where a judge in Berlin looks at what his or her New York counterpart has said, we cannot view each decision as isolated instances of dispute resolution. Rather, the

100 Waibel "Opening Pandora's Box", above n 8, at 719.
101 At 739.
102 Tomer Broude "Fragmentation(s) of International Law: On Normative Integration as Authority Allocation" in Tomer Broude and Yuval Shany (eds) *The Shifting Allocation of Authority in International Law: Considering Sovereignty, Supremacy and Subsidiarity* (Hart Publishing, Portland, 2008) 99 at 99.
103 At 119.
104 Desierto, above n 44, at 56.
105 At XV.
106 Andrea K Bjorklund "Private Rights and Public International Law: Why Competition Among International Economic Law Tribunals Is Not Working" (2007) 59 Hastings Law Journal 101 at 117.
107 At 117.
108 Pauwelyn, above n 87.

submissions to jurisdiction in sovereign bond instruments have allowed various domestic courts to perform active roles in developing international law. This role is relatively "new" for domestic courts; for they involve disputes which implicate the actions of states which have historically enjoy "a privileged position before the domestic courts of other states."[109] Under such circumstances, coherence has a positive value. In its absence, judges have fractured one concept of state protection into a multitude of different sub-issues.

In carrying out this "new" role, municipal courts created a patchwork of protection for States that contradicts itself to the point of ineffectiveness. Different protections operate at different levels and operate to excuse different actions. For instance, necessity acts to "preclude the wrongfulness of an act not in conformity with an international obligation."[110] To do so, an internationally wrongful act must be established *before* a plea of necessity applies. In other words, the defence of necessity precludes wrongfulness *of* an act and exists as a secondary rule contingent on an assessment of wrongdoing. Meanwhile, the doctrines of immunity, act of state and non-justiciability are entirely different. They bar a domestic court from hearing the proceeding, regardless of whether or not a wrongful act has taken place. As such, these doctrines function as preclusion *from* wrongfulness. Despite their differences, these doctrines function to ultimately protect the same action: the state's modification of international obligations. Because of this vast difference, it is impossible to say that international law has fragmented in a positive way. It has cast complete uncertainty over the application of defences for a state's emergency actions. In this way, the proliferation of the ways for assessing a state's actions in self-preservation has fallen into a classic ground for critique of fragmentation: that there has been a total lack of unity in international law. From this reality, it is easy to see how the majority in the Constitutional Court found that no uniform approach to necessity exists across domestic orders.

To compound the issue, non-precluded measures clauses in investment agreements add another layer of complexity. Despite initial doubts expressed by Waibel, it is now accepted that sovereign bonds disputes constitute an "investment" for the purpose of ICSID Convention arbitration.[111] Where a treaty itself provides for emergency action in the form of "non-precluded measures" clauses, the assessment of a necessity claim will obviously depend on the state's treaty framework. While a detailed assessment of various treaty regimes is outside the scope of this article, it should be noted that the

109 Simon Olleson "International Wrongful Acts in the Domestic Courts: The Contribution of Domestic Courts: The Contribution of Domestic Courts to the Development of Customary International Law Relating to the Engagement of International Responsibility" (2013) 25 LJIL 615 at 625.

110 Crawford *The International Law Commission's Articles on State Responsibility: Introduction, Text and Commentaries,* above n 29, at 178.

111 See Waibel "Opening Pandora's Box", above n 8.

assessment of necessity claims arising out of a treaty adds another dimension of intricacy. These treaty clauses are tailored to various situations and their simultaneous existence alongside the conception of necessity under customary international law has spawned much debate.[112]

IV. Necessity

A. Problems within the Framework

Connected with the inappropriateness of domestic courts ruling on issues of sovereign debt is the growing concern that the framework of necessity itself is problematic.[113] In a short article contrasting two conflicting arbitration awards under the ICSID Convention related to utilities companies investing in Argentina, Michael Waibel suggests that the ILC framework is unsuited for dealing with economic necessity.[114] This section advances Waibel's critique in relation to sovereign bonds. It will argue that domestic courts are ill-equipped to adjudicate on an issue as indeterminate as sovereign debt using the ILC framework that has developed largely in light of the use of force. It is inappropriate for municipal courts to apply that framework against complex decisions that are largely considerations of foreign policy. Because of the lack of discourse on the contents of necessity from municipal courts, this section will largely borrow from the Argentine utilities arbitration cases.

In principle, it is accepted that extreme financial turbulence could establish a necessity defence.[115] Instances of its successful application, on the other hand, were few and far between. Rather, the formulation of necessity in art 25 of the ILC, as Waibel contends, sprouted out of attempts to justify instances of the use of force and self-defence.[116] That is, the law developed from violent responses to emergency. In cases involving violence, concepts such as a "grave and imminent peril" or "leaving no choice of means" are far more easily assessed. The end of a violent threat is easier to measure and it then makes "perfect sense" for states to resume normal international obligations to preserve peace.[117] But after a financial crisis has occurred, resuming "ordinary" or "aggregate" financial obligations at the level that they existed before the crisis (which essentially is what is demanded by holdouts) can be crippling. To revive all financial obligations

112 See generally Jurgen Kurtz "Delineating Primary and Secondary Rules on Necessity at International Law" in Tomer Broude and Yuval Shany (eds) *Multi Sourced Equivalent Norms in International Law* (Hart Publishing, Oxford, 2011) 231.

113 See Michael Waibel "Two Worlds of Necessity in ICSID Arbitration: CMS and LG&E" (2007) 20 LJIL 637; and Sornarajah, above n 56.

114 Waibel "Two Worlds", above n 113, at 640.

115 *Russian Indemnity (Russia v Turkey) (Award)* (1912) 11 RIAA 421. This has further been accepted by the Argentine utilities awards. See for instance *LG&E Energy Corp, LG&E Capital Corp, and LG&E International Inc v Argentina* ICSID Case No ARB/02/1, 3 October 2006 at [251].

116 Take for instance cases such as the Caroline Affair, which has contributed famously to both the discourse on necessity *and* self-defence.

117 Waibel "Two Worlds", above n 113, at 641.

not only hinders a sovereign's ability to rebuild its economic capacities, but resuming payments on debt at their original value could constructively sentence a State to default again.

A successful claim under art 25 requires a finding that the State did not contribute to the crisis and that its actions were the "only way" to resolve that crisis. First, financial crises are by nature difficult to assess in terms of what level of economic turmoil truly constitutes a "crisis". In essence, the test requires adjudicators to find that Argentina's default on its debt would be the only way of safeguarding its essential interest. Therefore, the test essentially requires adjudicators from a foreign jurisdiction to engage in an evaluation of the appropriateness of Argentina's economic policy response. At the same time, arbitrators in both *CMS* and *LG&E* found that they had no jurisdiction to do so.[118] In *CMS*, it was found that the availability of other policy measures, each of which could be supported by different experts, meant that it was not necessary to examine "the adequacy of macroeconomic policy in deciding on the applicability of necessity."[119]

In the context of financial crises, the "only way" test is wholly inappropriate. In many instances, where a State's sovereign debt portfolio has become unsustainable, financing is not a viable option without direct action to reduce a country's debt.[120] At the same time, however, the specific time and point where this occurs is difficult to pin down. Until then, a State has many alternative measures. As discussed above, States can seek bridging finance from the IMF, bailouts from other countries or impose austerity measures. Before its crisis, Argentina relied on a mixture of IMF funds, domestic banks and pensions to meet its increasing financing gap.[121] A State must decide on the best method, as there is often no such thing as an *only* method. However, to borrow from Sornarajah, a State "cannot afford detached reflection [from the] point of an uplifted knife" while chaos runs amok.[122] If the availability of alternative measures excludes a State from a necessity plea, then the test would be meaningless unless a State reaches the absolute ruin of its cash reserves. Thus, during an economic default, a specific policy is almost never the "only way" to abate disaster; finding that it either is or is not misses the point. The decision in *LG&E* can similarly be criticised on this point, despite the tribunal in that case allowing the defence.

The "no contribution" test is equally flawed. The *CMS* Tribunal concluded that Argentina's policies had contributed to the emergency, and while external factors did fuel difficulties, they did not exempt Argentina

118 At 645.

119 At 646.

120 Mark Allen "Some Lessons from the Argentine Crisis: A Fund Staff View" in Jan Joost Teunissen and Age Akkerman (eds) *The Crisis That Was Not Prevented: Lessons for Argentina, the IMF and Globalisation* (Fondad, the Hague, 2003) 120 at 148.

121 Anna Gelpern "Sovereign Debt and Banking Crises: An "Arial View"' in Rosa M Lastra and Lee Buchheit (eds) *Sovereign Debt Management* (Oxford University Press, New York, 2014) 25 at [15-29].

122 Sornarajah, above n 56, at 463.

from responsibility.[123] By contrast, the *LG&E* Tribunal's attempt to dodge the issue by placing the burden of proof on investors similarly falls flat. In fact, it is difficult to measure a State's contribution to the crisis. Certainly, no State deliberately adopts policies that would bring about a crisis. Endogenous factors and exogenous factors causing a fiscal crisis are difficult to differentiate. To this extent, some argue that the economic policies advocated by the World Bank and the IMF largely contributed to Argentina's crisis.[124] For instance, emerging markets can often only borrow in foreign currency,[125] perhaps for the investor's distrust of sovereign actions when borrowing in local currency.[126] Yet borrowing in foreign currency has been described as an "original sin", for it leads to rapid debt accumulation and difficulties servicing the debt when a depreciation in the real exchange rate occurs.[127] In this situation, it is almost impossible to measure the extent of a sovereign's contribution. The answer is not found in any of the arbitral decisions, which uniformly neglect to analyse the contribution requirement in any detail.[128]

The truth is that the "only way" and the "contribution" tests require assessments of macroeconomic policy. Taken together, these requirements raise questions as to whether domestic court judges and arbitrators are capable of ruling on these economic matters. We have seen that judges are ill-suited to make detailed decisions as to a sovereign's macroeconomic policy, to this end, it has been said that these adjudicators lack the sufficient "institutional capacity to afford complex analysis of the nexus requirement of the test."[129] Where economic action in emergency carries shades of grey, not the black and white of use-of-force action, it is difficult to accept the notion that a domestic judge is capable of deciding on such an indeterminate issue. After all, divergent views "lie in the nature of economic policy".[130] There is no "universal truth" in economics. Experts will proclaim a widely divergent set of views on the appropriate fiscal response to financial crisis. These will differ on the basis of training and ideology.[131] Indeed, it would be "invidious" for a tribunal to "sit in judgment and make decisions removed from the pressure of the situation that confronted the state."[132] It is therefore difficult to accept

123 *CMS Gas Transmission Company v Argentina (Award)* ICSID Case No ARB/01/8, 12 May 2005 at [329]; see also Waibel "Two Worlds", above n 113, at 642-643.

124 Sornarajah, above n 56, at 463; and Ha-Joon Chang *Bad Samaritans: The Myth of Free Trade and the Secret History of Captialism* (Bloomsbury Press, New York, 2008) at 180.

125 Allen, above n 120, at 149.

126 Anastasia Guscina, Guilherme Pedra and Gabriel Presciuttini *First-Time International Bond Issuance – New Opportunities and Emerging Risks* IMF Working Paper, WP/14/127 (2014) at 12.

127 See generally Barry Eichengreen, Ricardo Hausmann and Ugo Panizza "Original Sin: the Pain, the Mystery and the Road to Redemption" (paper presented to Currency and Maturity Matchmaking: Redeeming Debt from Original Sin, Washington DC, November 2002).

128 August Reinisch "Necessity in Investment Arbitration" (2010) 41 Neth YB Intl L 137 at 148.

129 Youngjin Jung and Sangwook Daniel Han "Sovereign Debt Restructuring under the Investor-State Dispute Regime" (2014) 31 J Intl Arb 75 at 95.

130 See Waibel, "Two Worlds", above n 113, at 646.

131 Desierto, above n 44, at 149.

132 Sornarajah, above n 56, at 463.

the transposition of a test founded on the use of force into situations where a state no longer can meet its debt gap. It is even more problematic to empower adjudicators to rule on the issue where a State has a variety of policy responses available, moving away from the idea that states are the "loci of power and authority in classic international law".[133]

B. Rebalancing the Necessity Test

The right for a State to discharge its sovereign obligations should not be taken to mean that necessity is self-judging or completely "pre-legal".[134] To do so would render the defence indeterminate and outside the scope of meaningful legal assessment. Rather, Burke-White and von Staden have suggested that a margin of appreciation should be granted to States.[135] Van Harten puts forward a similar argument, taking note of the fact that investment arbitrations have far-reaching implications for the governance of societies around the world, deciding on the legality of legislative, executive and judicial acts.[136]

While these arguments were made in the context of investment tribunals and investment agreements, the line of thinking is worth considering in the context of sovereign debt management before domestic courts. An approach should seek to balance the interests of the creditor and the right of a State to act in the basic interests of their citizens, rather than an automatic legalistic interpretation of art 25. This is especially the case since adjudicators are ill-equipped to rule on sovereign debt management. During ordinary domestic litigation, courts often seek to balance the rights of the claimant against societal interests and the rights of the state.[137] After all, according to Lord Devlin, "[t]he administration of justice is a matter of balance and adjustment."[138] There is no reason a different approach should apply where the courts of one State adjudicate on another sovereign's debt obligations. Because a State submits to the jurisdiction of a foreign court in a bond document, the state essentially allows the foreign municipal court to adjudicate on matters of its public, much in the same vein as the power granted to an investment tribunal. Thus, the foreign court plays an important function vis-a-vis the citizens of the submitting state.

In the context of sovereign debt management, the actions and societal interest of a State should be balanced against the interests of creditors. In many instances, deference should be made to the actions of the state in

133 Vadi, above n 69, at 48.

134 Reinisch, above n 128, at 148.

135 See generally 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" (2008) 48 Va J Intl L 307.

136 See Gus van Harten *Sovereign Choices and Sovereign Constraints: Judicial Restraint in Investment Treaty Arbitration* (Oxford University Press, Oxford, 2013).

137 Chester J Atineau *Adjudicating Constitutional Issues* (Oceana Publications, London, 1985) at 123.

138 Patrick Devlin *The Judge* (Oxford University Press, Oxford, 1979) at 200.

protecting its citizens. Submissions to the jurisdiction of a municipal court are too often treated as waivers of sovereignty. As such, domestic courts encourage a dangerous mentality, allowing creditors to assume that their lending is a failsafe investment without reading the loan document. Lending is an inherently risky enterprise. The risk posed to would-be investors is often reflected in the interest rate that accompanies the bonds. Moreover, bondholders are profit seeking entities or individuals and the majority of holdout litigators consist of vulture funds relying entirely on the lack of state bankruptcy protection in order to attain a profit.

In contrast to the restricted leash of emergency action given by domestic courts, two arbitration awards have signalled a consideration of this more deferential approach. First, the *LG&E* Tribunal recognised that the "charges imposed were the result of reasoned judgment rather than simple disregard of the rule of law".[139] According to Sornarajah, the case can be seen as an attempt to "accommodate the defence in the context of the situation that faced Argentina" amidst mounting criticism of prior awards.[140] In this sense, the Tribunal allowed Argentina latitude for emergency action. Second, the *Continental Casualty* Tribunal applied an approach where investors' rights and interests were considered against Argentina's needs in responding to an urgent financial crisis.[141] This legal reasoning was significantly different from the other arbitral decisions in its active attempts to balance the priorities of the state against the interests of investors.

Nonetheless, it is uncertain whether *Continental Casualty* and *LG&E* will remain as examples of judicial restraint.[142] *Continental Casualty* applied a GATT approach to necessity based on its reading of a non-precluded measure in the investment agreement. Moreover, subsequent tribunals have retreated from this "balancing" approach. For instance, *EDF* continued to read the defence of necessity narrowly, while the *Total* Tribunal approached Argentina's claims strictly under the context of customary international law without reference to the *Continental Casualty* restraint-based approach.[143] The law is unclear going forward and different outcomes are reached by domestic and international tribunals. While the reasoning of more recent adjudication impliedly moves towards a more deferential approach, no tribunal or court has solely relied on the right for a State to protect its citizens as a substantive factor in its decision.

It should be noted, however, that the approach advocated above has a number of complex implications. For instance, sovereign borrowing could become more expensive. Because sovereigns have more remedies if they fall in default, the market may then price the interest rate higher in order to reflect that risk. If so, then difficult questions arise as to whether increases in the cost of borrowing in exchange for greater remedies in default would be in the

139 Martin, above n 70, at 66.
140 Sornarajah, above n 56, at 464.
141 van Harten, above n 136, at 66.
142 See van Harten, above n 136, at 67.
143 At 67-68.

interests of borrowing states. Whether this line of argument would hold true, however, is uncertain given the great range of circumstances which go into the pricing of sovereign bonds.

Nevertheless, this approach should be given further consideration. A more flexible balancing approach would give due recognition to the multitude of stakeholders behind a sovereign default. It is an approach that seeks to duly recognise the imperative for a State to provide for the essential interests of its citizens and respects the emergency action of a State. Instead of a strictly legalistic approach according to an anachronistic necessity framework, the balancing of interests requires a closer examination of a state's payment capacity, as advocated by Waibel.[144] This would more accurately address the problem that is at the heart of sovereign debt restructuring – the need to maximise the equilibrium between a state and its citizens, foreign creditors and the interest of third-party states (and their tax payers) that would likely have to fund a bailout.

V. Conclusion

According to Crawford the "recognition [of economic necessity] as a possibility is usually followed by a denial of its applicability."[145] Although the idea of necessity is commonly accepted, the many ways in which it can occur have led to a fractured understanding of necessity's utility. In the Federal Constitutional Court decision, a seven-to-one majority judgment rejected the application of the doctrine to excuse a State's non-performance of debt obligations it entered into with private creditors. In essence, the decision effectively challenges the ability of a state to act in the best interests of its citizens.

At the core of necessity is a simple concept. It is that in some circumstances, a state must be able to alter its international obligations in order to ensure its own self-preservation. As a matter of constitutional principle, this concept of self-preservation must include a state's duties to ensure the basic needs of its citizens. However, this idea is problematic in two ways. First, the core concept manifests in different forms, resulting in a patchwork framework of protection for states. Because the framework is often contradictory and offers different forms of protection for states, the overall system for a state to plea for exemptions to its international obligations is undermined and the search for a uniform approach is utopian. Second, despite the submission to jurisdiction contained in bond documents, domestic courts are inappropriate forums for adjudicating instances of economic emergency and sovereign bonds, using a test under art 25 that is ill-suited for instances of economic necessity in the first place.

144 Waibel "Two Worlds", above n 113, at 644.

145 James Crawford *Brownlie's Principles of Public International Law* (8th ed, Oxford University Press, Oxford, 2008) at 564.

In light of these issues, it is clear that the minority judgment of Lubbe-Wolff is preferred for reaching a position that is justifiable both commercially and theoretically. Faced with a situation where a black-and-white answer is impossible, adjudicators should allow leeway for sovereign states to regulate in the best interest of their citizens. Only such an approach would holistically take into account the different factions of stakeholders linked to a sovereign in default.