SELECTIVE DISENGAGEMENT OF FOREIGN SOVEREIGN DEBTS: A PROLEGOMENON

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1. INTRODUCTION

The combined outstanding foreign debts incurred by the world's less developed countries (LDCs) was estimated at 1,320 billion U.S. dollars in 1988,[1] up from 1,281 billion dollars in 1987.[2] The obvious burden imposed by these external debts on fragile LDC economies has provoked calls for the reappraisal of the international debt situation, and has driven Third World states to reevaluate their obligations relative to such debts.[3]

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1 I.M.F. SURVEY, 9 January 1989, p.1, citing World Bank data report entitled WORLD DEBT TABLES, 1988-89. Of the total amount, seventeen states constituting the world's highly indebted LDCs accounted for 529 billion U.S. dollars. The highly indebted countries are: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cote d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela, and Yugoslavia.

2 *Id.* Estimates do vary. For instance, at the end of 1985, the total LDC debt was variously reported at $916 billion by the International Monetary Fund (*World Economic Outlook*, October 1986); $950 billion by the World Bank (*World Debt Tables*, 1985-1986); $991 billion by the Organization for Economic Cooperation and Development (*Financing and External Debt of Developing Countries*, 1985). For a discussion of the discrepancies, see Weaving, *Measuring Developing Countries' External Debt*, 24 FINANCE AND DEVELOPMENT 16 (1987). A group of writers, however, is of the opinion that the developing countries' liabilities are probably far greater than the highest estimate quoted above since international statistics do not include 'military aid' loans and do not adequately register loans which run for less than a year. If, for instance, the total Third World debt reported at $895 thousand million at the end of 1984 took military loans into consideration, the overall debt was then close to one billion U.S. dollars [KORNER, MAASS, SIEBOLD, AND TETZLAFF, THE IMF AND THE DEBT CRISIS 5 (1986)].

3 J. Epstein, in his work *The Political Economy of the Debt Crisis* in 64 ECONOMIC IMPACT 59, 61-63 (1988), has formulated a taxonomy of proposed solutions to the debt crisis, based on the types of systemic reforms they require, consisting of six (6) broad "families" of ideas. Four of them are (see notes 4 and 5, *infra.*, for others): (1) "Conventional" proposals which include all restructuring approaches involving rescheduling and refinancing. Among the best known of these is the Baker Plan of 1985 associated with the then U.S. Treasury Secretary. (2) "Innovative proposals within the existing system" involve a linkage between debt service and volume or trend of exports, growth or production. These include the adoption of a certain percentage of export proceeds as a ceiling for debt service as adopted by Peru as well as the proposal to index debt service to the growth of the debtor country's economy. (3) "Innovative proposals with major system changes" are represented by refunding solutions. A recent proposal calls for the establishment of the Institute of International Debt and Development or I2D2 to be financed by the member governments of the Organization for Economic Cooperation and Development, the World Bank, the IMF, as well as by creditor private commerical banks who would purchase shares of I2D2 in exchange for their loans to the participating debtor countries. Under the plan, "I2D2 would issue bonds in the form of consols (perpetual debt) and trade the proceeds for debt at market rather than face values."

Much heat has been generated in arguments over which sword to employ, if at all, in cutting through the Gordian knot of debt that inextricably ties creditors and debtor-states together. A good deal of emotion has been expended particularly in debates over the merits and demerits of partial forgiveness or total cancellation of sovereign debts by creditors,[4] and the unilateral denunciation of all debt obligations by the debtor-countries.[5] Still, it is certainly of some legal significance that proponents of the latter alternative have striven to present it as an ultimate remedy grounded not solely on meta-legal considerations.[6]

The various discussions concerning systemic solutions to the debt crisis, however, have thus far failed to generate adequate light for illuminating a common path for creditors and sovereign debtors and have obscured the need for an examination of the availability or non-availability of legal remedies for extricating debtor-states from part of or their entire obligations. While a long-term solution may require political intervention and the mutual consent and cooperation of debtors and creditors, an understanding of the available legal alternatives in individual loan transactions as well as in their totality can enable the debtor-nations to assess with a greater degree of accuracy, and perhaps enhance, the over-all strength of their bargaining position.

The overthrow of authoritarian regimes in a number of LDC debtor-countries[7] has provided additional momentum to the reexamination process. The added drive is quite understandable since the governments concerned came to power as part of popular responses against dictatorial regimes accused of, among others, contracting debts which did not in any way benefit the people who were bound to repay them. At the same time that these governments have shown stronger interest in the possibility of eschewing their debt obligations, there has been a perceptible shift in the foci of their attention from the purely political to the legal bases of such an alternative. The following study was undertaken with the view of

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(4)"Transformative" proposals involve conversion of debt into equity and similar forms. These are exemplified by, among others, debt-for-equity and debt-for-nature swaps.

4 Epstein, *id.*, classifies these in a family of "controversial solutions" including debt relief, write-downs, write-offs, conciliatory default and partial debt forgiveness. While these options have been exercised by creditor states relative to some of the debt of the world's *least* developed countries (LLDCs), the debt owed by such countries is only around ten percent of the aggregate debt of LDCs and is owed mostly to states and not to private commercial banks.

5 Epstein, *id.*, classifies this under "radical proposals" which include unilateral moratoria on debt repayments and outright debt repudiation

6 Fidel Castro, for instance, has pointed out that in exploring solutions to the debt dilemma, "[A]ll the moral, political and economic arguments could be complemented with a whole series of legal arguments." F. CASTRO, SPEECH AT THE CLOSING SESSION OF THE MEETING ON THE FOREIGN DEBT OF LATIN AMERICA AND THE CARRIBEAN 48 (1985). See also interview with Fidel Castro in *Unpayable and Illegal*, 43 NAT'L LAWYERS GUILD PRACTITIONER 33-37 (1986).

7 Including Brazil, Argentina, the Philippines, Uruguay, Pakistan and Nicaragua.

examining, from the general standpoint of Third World debtor-states, the various legal possibilities related with the foregoing choice of action.

The employment of the term "selective disengagement" is, thus, not without a purpose. It is not a mere euphemism for terms which a creditor with a good eye on his money may find disconcerting; it is intended to highlight the commitment to a search for solutions to the debt problem within the context of law. Central to the concept it represents is the identification of principles and approaches that would legally excuse, temporarily or permanently, a debtor-state from all or part of its foreign debts. The approach is selective, not indiscriminate; the underlying premise is that a state's alternative to disengage itself of its debts is available only where there is a legal anchor for it. The phrase "selective disengagement" is devoid of the emotional baggage, both legal and non-legal, which other related terms often carry. Take, for instance, the term "repudiation". As a technical term, it has been widely used to refer to a declaration by a sovereign debtor that it will not meet its foreign debt liabilities,[8] as well as to acts attributable to the state which produce the same effects.[9] "Repudiation" in that sense could cover both legal and illegal action by the debtor since the distinction does not inhere in the definition of the term. Perhaps, precisely due to the absence of such a distinction, "repudiation" has been associated by many writers and in the public's mind more with the "wilful breach" of agreements which is violative of law.[10] Thus, the term's use in this study will not serve its purpose.

Selective disengagement differs from the approach adopted in renegotiations of foreign sovereign debts. Renegotiations may result in a restructuring of the debt through refinancing (wherein creditors provide new loans to pay off old ones), or rescheduling (wherein creditors extend a debtor's repayment schedule) or similar arrangements. Renegotiations, like the voluntary forgiveness of the debt or part of it by the creditor, require the consent of the creditor. Selective disengagement, in contrast, may acquire legal effects with or without the creditor's consent. However, since

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8 For example, P. WOOD notes in his work LAW AND PRACTICE OF INTERNATIONAL FINANCE at 4-76.1 (1984) that: "A state repudiates where, whether or not in a position to meet its foreign currency liabilities as they fall due, it declares it will not meet those foreign currency liabilities..." Also, E. BORCHARD in his work 1 STATE INSOLVENCY AND FOREIGN BONDHOLDERS 129 (1951) states that "Repudiation constitutes a refusal to admit the binding character of an obligation."

9 Thus, Wood, *id.*, considers it an act of repudiation when a state "adopts other legislative measures which have the effect of expropriating its creditors." He further states that "Such measures include whole or partial cancellations, the imposition of excessive exchange controls or taxes, conversion of foreign debt into irredeemable local currency scrip and other acts amounting to a constructive taking."

10 Among the more well-known welshers in the last century were various states of the United States of America which refused to honor debts incurred by them from foreign creditors. See R. MCGRANE, FOREIGN BONDHOLDERS AND AMERICAN STATE DEBTS (1935).

the disengagement contemplated herein is a selective one, the renegotiation of those debts, or parts thereof, which cannot be disengaged is compatible with the selective disengagement of other debts where this could be properly carried out.[11]

The phrase "foreign sovereign debts", on the other hand, describes more tersely than any other string of words such sums of money or other medium of exchange or value owed by a state to a foreign claimant by virtue of a loan agreement or credit arrangement, or ownership of bonds or other securities issued by a state.[12] The phrase can also apply to debt obligations originally incurred by other parties but voluntarily assumed by a state, debts contracted under agreements involving foreign creditors and a debtor which is not a state but where the state is directly and primarily liable for the debt, as well as to debt agreements where the state is subsidiarily liable but the trigerring events for state liability to attach have occured. The reason for the inclusion of such debts under the rubric of "sovereign debts" is clear: in these specified cases, the net legal liability of a state would have the same impact as in those instances where it directly incurred the debt.

The immediate focus of the present study, however, is on those obligations of a state to a foreign claimant under which the latter is owed, by virtue of a loan agreement, a sum of money or other medium of exchange or value. While not attempting to ignore completely the other species of sovereign debts, the present study applies to them only to the extent that they share similarities with those contracted under a loan agreement contracted directly by a state.

Debts owed by a state to its own nationals are excluded; but all debts owed to foreigners--whether states or state organs, or private, natural or juridical persons--are included. Differentiating sovereign debts based on

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11 Selective disengagement may also be distinguished from state default and state insolvency. Events of default specified in a debt agreement describe those circumstances in which the lender has the right to terminate the lending commitment and to declare due and payable any outstanding loans. A debtor is in default when such circumstances have taken place and the creditor declares the former in default. Selective disengagement, on the other hand, may avoid the very debt agreement under which a state of default may arise or, at the very least, may protect the debtor from the legal consequences of being declared in default. State insolvency arises when a debtor fails to meet current foreign debt liabilities, but as one writer has pointed out, the term by itself "has no particular legal resonance in the sense of crystallizing creditor rights available under general law." However, the debt agreement may provide that a state which fails to pay its current liabilities is in default. State insolvency may constitute a ground for selective disengagement, but the latter is not preconditioned on a state's insolvency.

12 Somewhat differently put, but amounting to the same thing, the phrase is broad enough to cover all types of creditor claims simpliciter "in which the foreign claimant is owed a sum of money by virtue of a loan agreement, ownership of bonds or other securities, or a supply or services contract". G. WHITE, *Wealth Deprivation: Creditor and Contract Claims* in INTERNATIONAL LAW OF STATE RESPONSIBILITY FOR INJURIES TO ALIENS 149 (Lillich ed. 1973).

this criterion is necessary since, under international law, the home state of a foreign private creditor may extend diplomatic protection to its national.

While most writers employ interchangeably the terms "lenders" and "creditors", as well as "borrowers" and "debtors", the terms "debtors" and "creditors" would more accurately describe the status of the parties once the legal vinculum under a loan agreement is established and are therefore employed in that sense throughout the paper. The terms "borrowers" and "lenders" are generally employed in referring to the parties where the legal vinculum need not necessarily have been established.

As a survey, this study does not focus on the particularities of the debts contracted by a specific debtor-country, nor is it intended to catalogue and analyze each and every type of debt arrangement entered into by debtor-countries and their respective creditors. The variety in the terms and conditions of debt agreements between sovereign debtors and creditors and the unique circumstances surrounding the conclusion and performance of each will require a case-to-case consideration which is precluded from the scope of this inquiry. Instead, the study concentrates on the more prevalent types of loan agreements, as identified by legal scholars and practitioners in the field, and the major grounds for selective disengagement which are applicable generally to them.

2. SETTING THE BOUNDS OF THE SEARCH FOR THE APPLICABLE LAW OF DISENGAGEMENT

As earlier stressed, the determination of the availability of selective disengagement as a remedy has to be made within the matrix of an applicable law since loan agreements cannot exist in a legal vacuum. Toward the identification of the possible grounds for selective disengagement, a survey of the applicable bodies of law in typical loan agreements is in order. In the following survey, the constant element is the sovereign character of the debtor while the principal variable is the legal status in international law of the creditor. Creditors are thus classified into international law persons and private law persons. The former refers to states, which are the primary subjects of international law, and international organizations--created by multilateral conventions among states--which have become prime legal actors on the international plane. The phrase "private law persons" comprehends all other creditors which have not gained-- as unequivocably as multilateral organizations--acceptance as subjects of international law, and which act with legal effect primarily on the plane of municipal law.

Other writers have distinguished between development lending and commercial lending, depending on the nature of the lender and the purpose for which the loan is made. On the financial side, economic development loans are no different from commercial loans. Unlike the latter, however, economic development agreements usually require covenants which have technical, economic and legal implications such as "covenants calling for structural administrative reforms, legislative action such as that respecting changes in rates or tariffs, or treaty commitments, such as those regarding the economic uses of international waters, railways and ports."[13] While such a distinction can be useful, it need not complicate our study at this point.

The terms "applicable law" or "governing law" should be understood in a broad sense to refer, not only to one particular body of law governing the agreement or the principal body of law governing it, whether expressly designated by the parties or not, but, as will be clarified in subsequent discussions, to the several bodies of law each of which may be applicable to different aspects of a loan agreement.[14] Thus, the search for disengagement must be made in each of those bodies of applicable law.

2.1. *Loans extended by international law persons*

2.1.1 Loans by states

Under international law, a state, in the exercise of its sovereign powers, may enter into a loan agreement, in whatever form, with another state or states. An agreement between states, though, does not necessarily constitute an international agreement which is governed by international law.[15]

Whether international law applies or not to the agreement is ascertained in relation to the intention of the contracting parties.[16] The *prima facie* presumption, though, is that an agreement between states is governed by international law in the absence of a choice of law clause to the contrary. Thus, it is not an unusual practice to be silent on the governing law in loan agreements concluded among states. The presumption arises from the possession of international personality by the contracting parties. It is also founded on the principle of sovereign equality of states. A presumption that an agreement between states is subject to the municipal

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13 Delaume, Law and Practice 14 (1983).

14 *See* Part 2.4, *infra.*

15 It has been the practice of states to provide expressly for the application of the municipal law of one of the parties as the governing law of some loan agreements. This is discussed further below.

16 The intention of the parties may be gleaned from the form of the agreement as well as "the detail with which the parties in the agreement have specified their own rules for contractual performance." D. O'CONNELL, 2 INTERNATIONAL LAW 976 (1970). O'Connell goes on to state that: "Clearly a commercial agreement in treaty form is governed exclusively by international law; so too, at least presumptively, is an agreement not in treaty form but which sets up a coherent regime of rules for its execution which render it substantially independent of municipal law for the attainment of the common goal." But see note 19, *infra.*

law of one of the contracting parties would run counter to this general principle.

The Vienna Convention on the Law of Treaties of 1969,[17] which is specifically applicable to a written international agreement contracted between or among states, contains the qualification that in order for an agreement to qualify as a treaty under the Convention, the agreement must be governed by international law.[18] Thus, the Convention does not rule out the existence of agreements between states that are not governed by international law; they are only taken out of the scope of the Convention's application. Every agreement between states, however, which is in written form and governed by international law, would fall within the coverage of the Convention.

By virtue of their sovereign powers, the states parties to a loan agreement are free to specify a governing law other than international law in the loan agreement. The view that agreements between states must be governed by international law has not prevailed. States may provide for the application of another body of law like the municipal law of the lender, the borrower, or a third state. Thus, the often-cited agreements covering loans extended between 1966 and 1968 by the Danish government to other countries provide for the application of Danish law in the following manner:[19]

> Unless otherwise provided for in the Agreement, the Agreement and all the rights and obligations deriving from it shall be governed by Danish law.

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[17] U.N. Doc. A/Conf. 39/27 (1969). Hereinafter referred to as the Vienna Convention I.

[18] Article 2, on "Use of terms", states:

> 1. For the purposes of the present Convention:
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> (a) "treaty" means an international agreement concluded between states in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation.

[19] MANN, STUDIES IN INTERNATIONAL LAW 240 (19); also cited in DELAUME, 1 TRANSNATIONAL CONTRACTS 38 (1986). Mann states that the Danish loan agreements' choice of law clause "compellingly supports" his suggestion that States may, in agreements among themselves, impliedly agree upon the application of a municipal system of law to their contracts, "though the implication must be clear and necessary to override the presumption according to which, normally, States contract under public international law." He goes on to state that: "The Agreements under discussion do teach, however, that it would be wrong in the course of the process of construction to attach much significance to the form of the document. Denmark's Agreements are in a form which could equally be employed for treaties in the strict sense of the term."(Mann, *id.* at 254.) But it must be noted, that in agreements between states which do not stipulate a choice of law clause and from which one cannot make a "clear and necessary" implication that a body of law other than international law applies, the form will still assume considerable significance.

On the other hand, loans extended by the German government involve a two-tiered legal structure:[20] the amount of the loan and its broad outlines are covered by government-to-government agreements which are registered under public international law, whereas the loan agreement is negotiated between the borrowing government and the *Kreditanstalt fur Wiederaufbau*, a German government organ, and is governed by German law.[21]

The practice of registering agreements between states is in compliance with the requirements of the United Nations Charter which provides in Article 102 that:

> 1. Every treaty and every international agreement entered into by any Member of the United Nations after the present Charter comes into force shall as soon as possible be registered with the Secretariat and published by it.

Mere registration of an agreement with the United Nations Secretariat, however, would not be conclusive evidence of the applicability of international law to the terms of that agreement; neither would the registration of an agreement between states not governed by international law transform that agreement into a treaty under public international law. The U.N. Secretariat has clarified that registration "does not imply a judgement by the Secretariat on the nature of the instrument, the status of the party or any similar question";[22] nor does its action "confer on the instrument the status of a treaty or an international agreement if it does not

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20 FOREIGN DEVELOPMENT LENDING 230 (Rubin ed.1971).

21 *Id.*

22 Every volume of the United Nations Treaty Series contains the following "Note by the Secretariat":

> Under Article 102 of the Charter of the United Nations every treaty and every international agreement entered into by any member of the United Nations after the coming into force of the Charter shall, as soon as possible, be registered with the Secretariat and published by it. Furthermore, no party to a treaty or international agreement subject to registration which has not been registered may invoke that treaty or agreement before any organ of the United Nations. The General Assembly, by resolution 97 (1) established regulations to give effect to Article 102 of the Charter (see text of the regulations, vol. 859, p. viii).

The terms "treaty" and "international agreement" have not been defined either in the Charter or in the regulations, and the Secretariat follows the principle that it acts in accordance with the position of the Member State submitting an instrument for registration that so far as that party is concerned the instrument is a treaty or an international agreement within the meaning of Article 102. Registration of an instrument submitted by a Member State, therefore, does not imply a judgment by the Secretariat on the nature of the instrument, the status of a party or any similar question. It is the understanding of the Secretariat that its action does not confer on the instrument the status of a treaty or an international agreement if it does not already have that status and does not confer on a party a status which it would not otherwise have.

already have that status."[23] The same can perhaps be said of the practice of individual states of publishing international agreements in national treaty reports. Similarly, a state requirement of ratification of treaties by a particular body, such as the legislature, will not necessarily give rise to a conclusive presumption of the applicability of international law as the governing law of the loan agreement. However, both practices may buttress the presumption in favor of international law where no choice of law clause has been provided for.

2.1.2. Loans by international organizations

International lending organizations which possess inter-national personality and are empowered under their respective charters to contract agreements with other international persons regularly enter into loan agreements with states. In such cases, the presumption that in the absence of a specific choice of law clause international law is the governing law also prevails since the entities involved are subjects of international law.[24]

The International Bank for Reconstruction and Development is one such international organization which lends to its member-states. In the standard loan agreements of the IBRD, there is no specific recital of the governing law, but Section 10.01 of Article X of the General Conditions Applicable to Loan and Guarantee Agreements states:[25]

> **Enforceability.** The rights and obligations of the Bank, the Borrower and the Guarantor under the Loan Agreement and the Guarantee Agreement shall be valid and enforceable in accordance with their terms notwithstanding the law of any State or political subdivision thereof to the contrary. Neither the Bank nor the Borrower nor the Guarantor shall be entitled in any proceeding under this Article to assert any claim that any provision of these General Conditions or of the Loan Agreement or the Guarantee Agreement is invalid or unenforceable because of any provision of the Articles of Agreement of the Bank.

The same provision is found in the General Conditions Applicable to Development Credit Agreements of the International Development Association (IDA). The Asian Development Bank (ADB) has also adopted similar provisions.[26]

The interpretation given to provisions represented by that of the IBRD above is that such provisions, although formulated in a negative manner, remove the loan agreement from the reach of municipal law and

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23 *Id.*

24 J. SYZ, INTERNATIONAL DEVELOPMENT BANKS 199 (1974).

25 INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT, GENERAL CONDITIONS APPLICABLE TO LOAN AND GUARANTEE AGREEMENTS 20 (1985).

26 T. Atkeson, *The Asian Development Bank* in FOREIGN DEVELOPMENT LENDING, *supra* note 20, at 23.

effectively subject the same to international law.[27] It is to be noted that essentially the same legal result would be produced if the said provision were absent. But as one writer has pointed out, the clauses which prohibit the assertion of invalidity or unenforceability assume an added function: to assure that the determination of whether agreements made with member-states are consistent with the constitutive instrument of the lending institution is reserved to the executive body of that institution.[28]

The Inter-American Development Bank (IADB) follows a similar approach through the inclusion of the following clause in its loan contracts:[29]

> The rights and obligations established in this contract are valid and enforceable in accordance with its terms, regardless of the legislation of any given country and consequently neither the Bank nor the Borrower may allege invalidity of any of its provisions.

However, the IADB loan contracts stipulate further that in the event of a dispute, it shall be submitted for arbitration and that "(t)he tribunal shall proceed *ex aequo et bono,* basing itself on the terms of the contract."[30]

The practice of the IBRD is to register its agreements with the United Nations Secretariat[31] in accordance with the Regulations issued in relation to Article 102 of the U.N. Charter which provide for *ex officio* registration of agreements where the U.N. or one of its agencies is a party or depositary. Other international agencies of the U.N. follow the same procedure, but the IADB[32] and the ADB[33], which are not U.N. agencies, do not register the loan agreements they contract with states. As in the case of registration of agreements between states, the act of registration does not transform an agreement into one governed by public international law where a different law is applicable.

2.2. Loans extended by private law persons

2.2.1. Loans by non-governmental private law persons

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[27] A. Broches, *International Legal Aspects of the Operations of the World Bank* in 98 RECUEIL DES COURS 296, 345 (1959); also cited in DELAUME, LEGAL ASPECTS OF INTERNATIONAL LENDING AND ECONOMIC DEVELOPMENT FINANCING 82 (1967).

[28] Broches, *id.* at 362-370.

[29] E. Arnold, *The Inter-American Development Bank,* in FOREIGN DEVELOPMENT LENDING, *supra* note 20, at 62.

[30] *Id.* at 63.

[31] A. Broches, *International Bank for Reconstruction and Development* in FOREIGN DEVELOPMENT LENDING, *supra* note 20, at 82.

[32] Arnold, *supra* note 29, at 64.

[33] Atkeson, *supra* note 26, at 24.

The status of a loan agreement entered into by a state with a person which is not a subject of international law has undergone considerable development. For a long time, there has been considerable disagreement among writers as to the binding character of such an agreement on the contracting state. Although Grotius appears to have rejected the idea, other writers have been firm in their assertion that the state is above the law and, therefore, could not be bound under the terms of the agreement.[34] While debates persist today on the same issue,[35] states have entered into

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[34] E. Borchard cites various writers from the 19th century as having come to such conclusions as that

> "the sovereign cannot be subjected to legal rules; that he who contracts with him or the state has nothing but the state's honor and credit as a sanction, because the state cannot be sued, either in its own courts or the courts of the bondholder; that the contract is, therefore, aleatory or a gambling contract, depending for its performance entirely on the good faith and willingness of the debtor"

and that

> "if the state becomes insolvent or repudiates, such eventuality is a contingency which the creditor should have had in mind in concluding the contract or buying the bond, and that the state is as privileged to alter the terms of the contract or to violate it, as it was originally to enter upon it."

The debt agreement, following this view, does not give rise to a legal relationship between the contracting state and the private person. This position is derived from the view, with which Justice Oliver W. Holmes is associated, that there can be no legal right without a remedy; and that since in municipal law a state cannot be sued without its consent, the resulting agreement with the state does not create a legal obligation on its part. However, a subsequent U.S. case pointed out that the rule on the non-suability of a state is merely a matter of procedure which does not affect the legal and binding character of state contracts. It has also been pointed out that in dealing with state defaults, it has been the practice of private creditors and their home states as well as arbitral tribunals and debtor states to recognize the legal character of debt agreements. [See E. BORCHARD, 1 STATE INSOLVENCY AND FOREIGN BONDHOLDERS 4-8 (1951)]

The views presented above, were formulated at a time when choice of law clauses were not usually included in a debt agreement between a state and a private person, thus encouraging an exclusive focus on the plenary powers of the sovereign debtor. But there were also writers during the same period who maintained

> "that a state contracts a loan under the same legal conditions as any private corporation or individual; that the obligation of the contract is to be controlled by the law of contracts; and that when foreigners are creditors, these foreigners have the protection of international law for the fulfillment of their contract."

This school would be more in keeping with the desire of creditors to preserve the stability of commercial transactions between states or state organs on one hand and private persons on the other [BORCHARD, *id.* at 8 to 15].

Borchard cites a third school which "regards the transaction as a contract of public law, thus admitting the sovereign character of many of the motives and laws which authorize and support the loan, while yet insisting that the obligation is legally binding, whatever the bondholder may or may not have." He went on to explain, thus:

> "In the event of default, the very fact that the debtor is a state is a clear indication that the ordinary procedures of bankruptcy and sale of the debtor's assets for the benefit of creditors cannot prevail. Hence members of this third school, if we may so classify the dissenters from the first and second groups, refuse to consider the nonpayment as either privileged or unprivileged but as an operative fact which creates a number of consequences, legal and factual..." [BORCHARD, *id.* at 15 to 16.].

countless loan agreements which specify not only an applicable law but also the obligations of the borrower-state under the agreements.

2.2.1.1. No choice of law

Some early decisions, notably in the *Serbian*[36] and *Brazilian Loans*[37] cases, have upheld the general presumption that in a loan agreement between a sovereign debtor and a private creditor, the governing law of the contract would be the municipal law of the contracting state, in the absence of a choice of law clause to the contrary. In the *Brazilian Loans* case, the court noted: "It cannot be held that the intention of the borrowing State was to render some law other than its own applicable as regards the substance of its debt and the validity of the conditions laid down in respect thereof, unless there were, if not an express provision to this effect, at all events circumstances which would irrefutably show that such was its intention."[38] Some writers hold that this presumption is by now outmoded because it may not reflect the expectations of the parties.[39] It is criticized for failing to consider that the parties may have refused to specify the governing law of the contract, for reasons involving the prestige of the sovereign borrower,[40] but were cognizant of the fact that the legal system of the contracting state may not be sufficiently developed as to provide an adequate solution to legal issues related with the loan agreement, and hence, should not govern the agreement.

Not all domestic courts, however, have adhered to the *Serbian* and *Brazilian Loans* cases rule; rather, various approaches developed in conflict of law situations have been applied. Among them is the tacit choice or implied intention test where the choice of law is gleaned from provisions of the agreement such as the forum selected.[41] Another is the center of gravity test, also known as the "most significant relationship test", which provides a presumption that the body of law to be applied is

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35 The contemporariness of the debate is reflected in the commentary of the International Law Commission on Art. 31--on state of necessity--of the Draft Articles on State Responsibility which introduced a sentence in paragraph (8) with the clause that: "Although it is disputed whether an obligation exists under international customary law to honour debts contracted by the State with foreign private individuals..." 2 Y.B.INT'L.L.COMM'N. 36 at para. 8, U.N. Doc. A/CN.4/SER.A/1980/Add.1 (Part 2).

36 1929 P.C.I.J.(ser. A) Nos. 20/21 at 5.

37 1929 P.C.I.J.(ser. A) Nos. 20/21 at 93.

38 1929 P.C.I.J.(ser.A) Nos. 20/21 at 122.

39 DELAUME, LEGAL ASPECTS OF INTERNATIONAL AND ECONOMIC DEVELOPMENT FINANCING 100 (1967) [hereinafter referred to as LEGAL ASPECTS].

40 *Id.*

41 P. Wood, "Government Loans", p. 10 from *Banking Law and Practice 1985*, a series of papers from a Melbourne Conference published by Longman Professional in association with The Banking Law Association; B. Semkow, *Syndicating and Rescheduling International Financial Transactions: A Survey of the Legal Issues Encountered by Commercial Banks*, 18 THE INTERNATIONAL LAWYER 869, 904-905 (1984).

that with which the loan agreement is most closely connected.[42] Still another approach involves the application of presumptions usually directed to the law of the place of contracting or performance.[43] There are also so-called flexible methods, "including providing the most just result given the particular circumstances, applying the law of the state having the most urgent policy interest in having its law applied (the "governmental interest analysis approach") and omnibus theories incorporating various provisions of the conflicts restatement to achieve greater predictability in conflict resolution."[44]

2.2.1.2 Express choice of law

It is recognized in a number of municipal law jurisdictions today that states and private persons enjoy autonomy in the determination of the law applicable to their agreement. The July 19, 1984 amendments to the New York General Obligations Law, for example, "require that the parties' choice of the law of New York as the governing law of their agreement be given effect even if the parties or the transaction have no other relationship with the state", provided that the sum involved is $250,000 or higher.[45] On the other hand, "English law does not require any contact between the contract and the proper law since the English courts recognise that the parties may wish to subject their loan contract to a neutral or familiar legal system in which they have confidence".[46] Loan agreements between private foreign banking institutions and states, however, invariably provide for the application of the law of the lender's state.[47] At least in theory, though, the contracting parties may also stipulate the municipal law of the state of the borrower as the applicable law;[48] but foreign private banks are reticent to do so because this may expose them to the vagaries of municipal law changes effected by the borrower-state.[49] The parties may also refer to international law as the governing law, though these instances are admittedly rare.[50]

42 Wood,*id*; Semkow, *id.*

43 Semkow, *id.*

44 *Id.*

45 See Buchheit, *New York Choice of Law Rules Simplified* in 1984 BUSINESS L. R.; also DELAUME, TRANSNATIONAL CONTRACTS, *supra* note 19, at 23.

46 Wood, "Government Loans", *supra* note 41, at 7.

47 This often reflects the relative weights of the bargaining power of the parties. Various factors have been identified which account for the lending bank's insistence on the law of their state. See, for example, Wood, *id.*; Semkow, *supra* note 41, at 903.

48 Usually, these are found in loan agreements involving South American countries whose constitutions or laws only allow the law of the borrower to govern the contract. Of the loan agreements examined by L. Nurick ["Negotiation of Transnational Bank Loan Agreements Entered into by Developing Country Borrowers: Legal and Other Issues", at 80 (1982) prepared for the United Nations Centre on Transnational Corporations], former general counsel of the World Bank, two were governed by the borrowers' law, those of Colombia and Venezuela.

49 This will be discussed in Part 4.1, *infra.*

50 Wood, "Government Loans" *supra* note 41, at 9.

2.2.2. Loans by state agencies or state corporations

A state agency such as a ministry or department may bind a state under international law, depending on the state's internal law which governs the authority or capacity of the state organ. A loan agreement contracted with another state by a properly authorized state agency would have the same status as an agreement between states.

However, although not authorized to bind the state in international law, where the state agency--such as a state corporation or government department--possesses a separate legal personality or is empowered to act with legal effect under municipal law and as a result thereof has the capacity to extend loans on its own right, it is logical to expect that the resulting loan agreement with a foreign state binds only the state agency or corporation and not the state of which it is an agency or subdivision. In such cases, the presumption regarding the application of international law as the governing law, in the absence of a choice of law clause, would not apply since not all the contracting parties are international persons. It would further follow that the resulting agreement would be on the same legal footing as those which a borrower-state contracts with persons who are not subjects of international law.

Lending institutions which are not international persons, like the the Export-Import Bank of Japan[51] and the Commonwealth Development Corporation,[52] provide for the application of their own state law. While the United States Agency for International Development does not specify an applicable law for its loan agreements with states, preferring instead to settle by negotiation,[53] its lack of international personality prevents the operation of the presumption that international law applies to the agreement. The Caisse Centrale de Cooperation Economique, on the other hand, refrains from stipulating the governing law in loan agreements; however, it extends loans principally to former French colonies which have adopted legal systems patterned after that of France.[54] Thus, whichever municipal law is eventually applied, the disparity between the law of the lender and the law of the borrower is greatly reduced. Still a different kind of arrangement has been developed by the Kuwait Fund for Arab Economic Development. Its loan agreements with other states contain a standard clause which is similar to that found in the IBRD Loan Regulations:[55]

> The rights and obligations of the Fund and the Borrower (or Guarantor) under this Agreement shall be valid and enforceable in

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[51] FOREIGN DEVELOPMENT LENDING, *supra* note 20, at 118

[52] *Id.* at 168.

[53] *Id.* at 176.

[54] A. Clerk, *The Caisse Centrale de Cooperation Economique* in FOREIGN LENDING, *id.* at 102-103.

[55] I. Shihata, *Kuwait Fund For Arab Economic Development*, in FOREIGN LENDING, *id.* at 137 *et. seq.*

> accordance with their terms notwithstanding any law to the contrary. Neither the Borrower (or Guarantor) nor the Fund shall be entitled under any circumstances to assert any claim that any provision of this agreement is invalid or unenforceable for any reason.

However, the agreements further provide that in the settlement of disputes between the parties by arbitration, "the Arbitral Tribunal shall apply the general principles common under the current laws of the Borrower (or Guarantor) and the State of Kuwait, as well as the principles of equity."[56] According to the Fund's former senior legal advisor, a loan agreement under the Fund would therefore be subject, "first, to its own terms and conditions; second, to the principles common to the laws of Kuwait and the other party; and, third, to the principles of equity."[57] The same writer has explained further that the principle of equity should be taken in its conventional sense in international arbitration--*ex aequo et bono*.[58] Delaume suggests that because of such provisions, "it would seem that each Fund agreement is governed by its own legal system depending upon the 'general principles common' to the law of Kuwait and of the other party."[59]

There remain questions, however, over the specification of public international law as the applicable law to a loan agreement where one of the parties is not a subject of international law;[60] but this arrangement is still fairly uncommon[61] as to merit more extensive consideration in this paper.

2.3. Loans extended by international law persons and private law persons

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56 *Id.* at 141.

57 *Id.*

58 *Id.* at 142.

59 DELAUME, TRANSNATIONAL CONTRACTS, *supra* note 19, at 47. He notes that "the legal system of several Arab countries has been largely influenced by French law and that in those countries not only 'common principles' but identity of legislation can be found."

60 There are writers who contend that the effect of such a choice of law clause "would be to bestow on the other party international personality for purposes of particular contractual relations." An alternative interpretation is that despite the choice of international law as the governing law in an agreement involving a party which is not a subject of international law, the agreement remains "a complex of relations belonging to a municipal level, although it may be necessary to import international legal principles to interpret the contract and give it effect." Brownlie [PRINCIPLES OF PUBLIC INTERNATIONAL LAW 548-549 (1979)] is also of the opinion that the agreement is not thereby placed on the international plane, although the arbitrator in the *Texaco v. Libya* case, involving a concession agreement, held the contrary view.

61 Wood notes that "On rare occasions, public international law has been applied to commercial bank loan agreements...However, such a choice has been implied into contracts or honoured in a number of international arbitrations, including those involving members of the English judiciary as arbitrators: see, for example Sapphire International Petroleum Limited v NIOC[1967] 34 ILR 136 and BP v Libya [1979] 53 ILR 297." ("Government Loans", *supra* note 41, at 9.)

The lending arrangement known as complementary financing is structured in such a manner that an international lending institution's financing for specific projects includes, in addition to the loan made by the institution on its usual terms, a complementary loan extended by foreign private commercial banks and other private sources of finance.[62] The amount of the loan granted to a state by the lending institution like the IBRD, which is a subject of international law, would be ordinarily governed by international law;[63] but that portion of the loan extended by foreign private banks would be governed usually by domestic law as is common to loans extended by the private commercial banks.[64] The IADB has avoided a bifurcation in the principal applicable law of the same loan by having the IADB sign both parts of the loan; thus, there is no legal relationship between the foreign private banks and the borrower-state; the legal relationship is between the IADB and the private banks on one hand, and the IADB and the borrower-state on the other. Thus, the entire loan extended to the borrower-state is governed by international law.[65]

2.4. Applicable law common to loan agreements

Regardless of which law governs the debt agreement, the capacity of the borrower-state or the authority to bind a state or a person who contracts on behalf of that state, is determined by the internal law of the state represented.[66] Thus, the provisions of the constitution or the statutes in effect in the state concerned are the appropriate references for determining such capacity or authority. Limitations on borrowing capacity may include a ceiling on the amount, the formalities that have to be observed such as the approval or ratification of the legislature, or limitations on the law that may be applied to the agreement.[67] The usual practice of creditors is to ask for the submission of a memorandum from the proper officials in the borrower-state stating that the requirements of the internal law with respect to the foregoing points have been met.

The above case illustrates a situation where the municipal laws of a borrowing state would be applicable to certain aspects of a loan agreement notwithstanding the absence of a provision on this point or the specification of a governing law other than the law of the borrowing state.

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62 J. Levinson, *The Inter-American Development Bank*, in 2 INTERNATIONAL FINANCIAL LAW (Rendell ed. 1983) 105, 108.

63 See Part 2.1.2, *supra*.

64 See Part 2.2.1, *supra*; see also DELAUME, TRANSNATIONAL CONTRACTS, *supra* note 19, at 60.

65 Note that the IADB has followed the lead of the IBRD in inserting a validity clause in its loan agreements (See *supra* text accompanying note 29), but has introduced its own arbitration clause. J.Levinson, *supra* note 62, at 110, has interpreted the same clauses to mean that "Bank loan contracts...are not subject to the laws of any specific country, but are to be interpreted pursuant to their own terms...In making its determination, the arbitral tribunal is to proceed according to equity and justice, based on the terms of the contract."

66 DELAUME, TRANSNATIONAL CONTRACTS, *supra* note 19, at 37.

67 DELAUME, LEGAL ASPECTS, *supra* note 39, at 6 to 8.

The contracting parties to a loan agreement, whether all are international persons or not, may provide not only for a single governing law but for two or more laws to be made applicable to certain parts of the debt agreement.[68] This technique, known as *depecage*, is frequently employed and is in perfect consonance with the principle of the autonomy of the contracting parties. In such cases the determination of the availability of selective disengagement would have to be made in relation to the applicable law of the various parts of the debt agreement.

2.5. *The Proposed Approach*

Debtor-states may be far from likely to consider, in the absence of weighty considerations, disengagement from loan obligations they obtained from other states or multilateral organizations, or, for that matter, from governmental agencies of other states. There are practical reasons. The primary actors at the level of international law and relations are states and multilateral organizations. Each of these actors would hesitate to embarrass its fellow actors by so much as hinting at a suggestion that legal defects are present in transactions involving them. The perceived rewards that may be derived from ignoring possible grounds for selective disengagement from loans extended by international law persons may weigh considerably more than those to be gained from ceasing to feign ignorance of such grounds. Besides, states and multilateral financial institutions continue to serve as the principal sources of loans obtainable on concessional terms and aid.

Considered from a legal standpoint, "there is generally a hierarchy of creditors."[69] The preferred status of loans obtained from international law persons or government agencies is evident from the types of debts that are at times excluded from restructuring agreements "for reasons relating to the nature of the debt or the identity of the payee".[70] These debts, excluded from restructuring due to a debtor-state's "realization that certain types of obligations cannot be restructured without serious adverse consequences for the country's economy and long-term credit status" despite its "wish to restructure as much of its debt as is feasible in order to facilitate a quick return to manageable debt service levels", may include:[71]

a. loans made, guaranteed or insured by foreign governments or their agencies (including export credit agencies); and

b. loans made by supranational or multilateral lending organizations.

68 DELAUME, TRANSNATIONAL CONTRACTS, *supra* note 19, at 15 to 16.

69 P. Wood, "Government Loans", *supra* note 41, at 21.

70 M. Walker and L. Buchheit, *Legal Issues in the Restructuring of Commercial Bank Loans to Sovereign Borrowers* in SOVEREIGN LENDING: MANAGING LEGAL RISK 139, 142 (Gruson, Reisner eds. 1984).

71 *Id.*

These do not indicate, of course, that the above noted loans are not subject to restructuring. Gone are the days when loans obtained from foreign states enjoyed at all times priority in repayment;[72] instead, they are often restructured separately from commercial bank loans. However, loans from western multilateral financial organizations do still enjoy preference since they are perceived as part of a useful reconstruction machinery operated in the interest of all creditors.[73]

An additional legal point must be considered. A violation of loan agreements contracted by international law persons and governed by international law may, by itself, constitute a breach of international law. Thus, some caution is justified in pursuing selective disengagement as a particular course of action.

One should not refrain, however, from examining international law as a source of grounds for selective disengagement based on the foregoing considerations. An identified instance for proper disengagement, even if not pursued to its logical end, would be useful as a *quid pro quo* in negotiations for solutions, systemic or otherwise, to the debt dilemma.

Even if we are to concede that certain grounds for selective disengagement, such as those relating to fraud, are not as likely to be found in loans extended by international law persons as in loans extended by foreign commercial banks because of the absence or minimal impact of the profit motive in the former class of transactions, there remains a compelling necessity for exploring selective disengagement under international law. Relative to loans from foreign commercial lenders, the need for such a study arises principally from the following: First, where the municipal law of a state is the applicable law, the tribunal or arbitrator may apply international law rules which, under that state's law, form part of its municipal law. Second, although international law rules may not form part of a state's municipal law which is the applicable law of the agreement, the tribunal or arbitrator may proceed by analogy to international law rules when confronted with a case involving a sovereign debtor due to the absence of adequately developed approaches or rules in municipal law. Third, though in very rare cases, the applicable law might be international law itself. Fourth, where another state extends diplomatic protection to its nationals who are creditors of a state, the issue would be elevated into an international law question, regardless of the body of law expressly made applicable by the parties.

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72 WOOD, LAW AND PRACTICE, *supra* note 8, at 4.13-5h.

73 *Id.* at 4.13-5g. Wood adds that another consideration is that a default toward a multilateral organization like the IMF would constitute a default against its more than 140 member-states. This statement appears to equate the legal personality of the IMF with that of each of its member-states.

The necessity for such a study remains since, despite the blurring of "the long and firmly established doctrinal frontiers between (public) international law and the (private) law of contract...",[74]

> the simple transfer from one discipline of law to another would remain insufficient. From the diagnosed results, it does not follow that international law disappears in favour of a private law 'contractualising' the relationships between states and private law subjects.

Certain special problems associated with parties which are sovereign under international law "cannot be dealt with adequately using the framework of private law."[75]

For equally valid reasons, the search for grounds for selective disengagement should similarly take place in municipal law. In the many loan agreements between foreign private commercial lenders and debtor-states where municipal law is the applicable law, one has to apply that law first. One cannot have immediate recourse to the application of international law rules unless the applicable municipal law allows it. It is equally possible that even where there is a legal ground for selective disengagement in international law, a loan agreement may still be the subject of litigation in a municipal forum whose law is the applicable law of the loan agreement or which is granted jurisdiction over disputes arising from the agreement. Just as the converse is true, international law questions may be decided, at times, by analogy to municipal law rules.[76]

With the above considerations in mind, it is proposed that the search for grounds of disengagement be made on two planes: the level of international law, and, whenever possible, the level of municipal law. In rare cases, other systems of law--such as general principles of law, principles common to specified bodies of law--may also be applied, but even these would involve a reference to either or both of the above systems. The discussion on grounds for disengagement under municipal law, considering the immense variety among various municipal law systems, will necessarily have to be relatively sparse and more selective.

The proposed approach requires the sidestepping of complicated and unsettled issues relating to the process of determining the body of law to be applied in the light of choice of law and choice of forum clauses. These need not derail us from a discussion of the possible grounds for the selective disengagement of foreign sovereign debts; suffice it for the purposes of this paper that, regardless of the rules applied in the determination of the

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[74] G. Frankenberg and R. Knieper, *Legal Problems of the Overindebtedness of Developing Countries: The Current Relevance of the Doctrine of Odious Debts*, in 12 INT'L. J. OF THE SOCIOLOGY OF THE LAW. 415-438, 420 (1984).

[75] *Id.*

[76] See, generally, H. LAUTERPACHT, PRIVATE LAW SOURCES AND ANALOGIES OF INTERNATIONAL LAW (1927).

applicable law of the loan agreement, such an applicable law will be identified eventually. In the following discussion, the grounds for disengagement are grouped into two: those relating to the contracting of the agreement, and those relating to its performance.

3. GROUNDS FOR DISENGAGEMENT RELATING TO THE CONTRACTING OF LOAN AGREEMENTS

3.1. *Lack of Competence of Borrower-State or its Officials*

The internal law of a state, as we have seen, may lay down restrictions on its competence, or that of its representative to contract loans.[77] Where the fundamental law or constitution or a statute of the state authorizes only a specific individual or office to incur debts or requires the consent or approval of some internal public organ for loans to be contracted, or imposes a ceiling on the amount of debt that the state may incur or the purpose for which it may be incurred, or requires as a condition *sine qua non* to any loan agreement's attainment of validity its publication in an official gazette of the state, or prohibits the state from contracting loans governed by a body of law other than that of the borrower-state, or in any way qualifies the power to contract foreign debts, the limitation so imposed[78] cannot be modified or ignored by the contracting parties so as to vest legal capacity to contract on the debtor-state or its representative.

If the loan agreement is to be contained in a treaty, other limitations or requirements relating to treaties under municipal law, independent of any requirements under international law, may also apply in addition to requirements relating to loan agreements.[79] A legal distinction has been drawn between internal law limitations which affect the executive's power to conclude treaties and those which regulate merely the power to implement a treaty which has been concluded. It is the former type of limitations that can affect the validity of a loan agreement in treaty form.[80]

3.1.1. Under municipal law

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[77] See Part 2.4 *supra*.

[78] Examples of various limitations on capacity are discussed in DELAUME, LEGAL ASPECTS, *supra* note 39, at 6. For examples of municipal limitations, see, the discussion of requirements under Argentine law, W. Goldschmidt, *Transactions Between States and Public Firms and Foreign Private Firms (A Methodological Study)* in 136 RECUEIL DES COURS 203, 290 *et seq.* (1972), and, under Mexican law, F. Vasquez-Pando, *The Mexican Debt Crisis in Perspective: Faulty Legal Structures and Aftershocks*, 23 TEXAS INT'L. L.J. 171, particularly at 175 to 182 (1988).

[79] See United Nations Legislative Series, *Laws and Practices Concerning the Conclusions of Treaties* (ST/LEG/SER.B/3) cited in *Report of the International Law Commission to the General Assembly* in 2 Y.B.INT'L. L. COMM'N. 169, 240 U.N. Doc. A/CN.4/SER.A/1966/Add.1. at footnote 204.

[80] *Id.*

If the applicable law of the agreement is the municipal law of the borrower-state and the forum for resolving disagreements between the parties over the validity of the agreement is before the tribunals of the borrower-state, in all likelihood the limitations imposed by the internal law of the borrower would be upheld. A domestic tribunal of the borrower has no choice but to give full effect to the laws and policies of the state concerned. Thus, if under domestic law, non-observance of the requirements would render the loan agreement void, voidable, or unenforceable, the judgment would be to that effect, but where the forum is outside of the borrower-state, and even though the law which determines the competence of the state or its agents is the law of the borrower-state, the tribunal or arbitrator may not necessarily view the borrower-state's or its representative's lack of competence as a ground for the invalidation of the loan agreement. The foreign forum may insist that there is a difference between, on the one hand, recognizing that certain limitations are imposed by the domestic law of the borrower, and, on the other, determining the nature of the effect of a violation of such limitations on the validity of the loan agreement. Such an approach has some parallels in international law.[81] Thus, the foreign municipal forum may rule on the validity of the agreement differently from how such an issue would have been decided by a domestic tribunal of the borrower-state.

An approach which is not infrequently incorporated in loan agreements involving a borrower-state is for the lender to require that the borrower-state submit "an advisory opinion of an official government lawyer according to which the contract has to be considered completely valid."[82] Can such an opinion have the effect of "estopping" the borrower-state from bringing up the issue of its lack of competence to enter into the loan agreement? Principles similar to estoppel are also found in civil law, but it has been pointed out that from the viewpoint of the internal law of the borrower-state, whether a civil law or common law country, such principles may not be applicable against the state or departments of government. The advisory opinion, however, may have some importance "as far as it grants to the other party that its good faith cannot be questioned."[83]

A similar issue is presented by many loan agreements, particularly Eurocurrency loan agreements, where the borrower-state makes representations and warranties--relating to, among others, the status, powers, authority and legal right of the borrowing state--which should be correct not only when the loan agreement is signed but also throughout the effectivity of the agreement.[84] Incorrect representations or warranties constitute events of default.[85] From the viewpoint of the internal law of

81 See discussion *infra.* at Part 3.1.2.

82 Goldschmidt, *supra* note 78, at 300.

83 *Id.* at 56.

84 L. Nurick, *supra* note 48, at 53-54.

85 *Id.* at 301.

the borrower-state, the inclusion of such clauses would not cure the lack of competence of the state or its representative to contract a particular loan in the first place. There is no reason why this question should be treated otherwise where the forum is outside of the borrower-state. Such warranties and representations, however, might be recognized by tribunals, wherever they are located, as proof of the lender's good faith.

In cases where a loan agreement is deemed under municipal law to be, at the very least, voidable due to the lack of competence on the part of the state or its representatives, this may not necessarily mean that the borrower-state has no obligation to return to the lender what has been received under the loan. The tribunals may require, on the basis of equity or some positive rule of municipal law, that the state--to the extent that it has actually benefitted from the loan agreement--return to the lender who contracted in good faith the amount corresponding to that benefit.[86]

There is, however, a contrary view. Borchard, in his works on state insolvency has stated that a state can unilaterally repudiate a loan agreement where the officials purporting to represent the state did not have the legal authority to do so,[87] thus implying that the state need not return what it has received: In the words of Borchard:[88]

> Where in fact the loan contract is defective in law, either because there was no constitutional or legislative authority to contract the debt or because in other respects the rules of law governing a binding obligation were not observed, the repudiation may have a legal justification, and the creditor may not be deprived of any legal right, for in such cases his obligation from the beginning was not legally binding.

Applying the same principle, if the loan agreement is embodied in a treaty, and the requirements imposed by internal law for the validity of the treaty are not observed, then applying Borchard's solution, the borrower-state may treat such a treaty as non-binding on itself. In international law, however, the violation of internal law need not invalidate the loan agreement, as we shall see below.

3.1.2. Under international law

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86 But while the concept of unjust enrichment is quite widely recognized in municipal law systems, it would not necessarily require payment of any part of the loan where there was no benefit received.

87 E. BORCHARD, 1 STATE INSOLVENCY AND FOREIGN BONDHOLDERS 129 (1951); also, E. Borchard, *International Loans and International Law* in PROCEEDINGS OF THE AMERICAN SOCIETY OF INTERNATIONAL LAW (at its Twenty-Fifth Annual Meeting held at Washington, D.C., 23-25 April 1931) 135, 143 at footnote 18. It is notable that Borchard's statements were made in relation to the repudiation in the mid-19th century of certain debts owed by a number of U.S. states including Mississippi, Florida, Alabama, North Carolina, South Carolina, Georgia, Louisiana, Arkansas, and Tennessee.

88 *Id.*

Illustrations of the international law approach to lack of capacity may be found in the law of treaties. The legal effects of a defect in the capacity of a state in contracting treaty obligations is addressed in the Vienna Conventions on the Law of Treaties I[89] and II[90]. Article 46 of Vienna Convention I provides:

> 1. A State may not invoke the fact that its consent to be bound by a treaty has been expressed in violation of a provision of its internal law regarding competence to conclude treaties as invalidating its consent unless that violation was manifest and concerned a rule of its internal law of fundamental importance.

A similar provision is found in Article 46 of the Vienna Convention II.[91] Both Conventions also define when a violation is deemed to be manifest:[92]

> A violation is manifest if it would be objectively evident to any State conducting itself in accordance with normal practice and in good faith.

The *travaux preparatoires* of the earlier of the two Conventions indicate that a violation of the internal law of the state relating to capacity which falls within the coverage of Article 46 is exemplified by actual cases of heads of state entering into treaties on their individual responsibility in violation of "an unequivocal provision of the constitution."[93]

The Conventions limit the applicability of Article 46 to cases where the violation is manifest and the rule violated is of fundamental importance. The International Law Commission's major concern in drafting this provision was that "the complexity and uncertain application of provisions of internal law regarding the conclusion of treaties creates too large a risk to the security of treaties."[94] They considered that[95]

> the basic principle of the present article should be that non-observance of a provision of internal law regarding competence to enter into treaties does not affect the validity of a consent given in

89 Vienna Convention on the Law of Treaties Between States, U.N. Doc. A/CONF. 39/27 (1969).

90 Vienna Convention on the Law of Treaties Between States and International Organizations or Between International Organizations, U.N. Doc. A/CONF. 129/15 (1986).

91 Article 46 (2) provides: An international organization may not invoke the fact that its consent to be bound by a treaty has been expressed in violation of the rules of the organisation regarding competence to conclude treaties as invalidating its consent unless that violation was manifest and concerned a rule of fundamental importance.

92 Article 46 (2) of Convention I and Article 46 (3) of Convention II.

93 2 Y.B.INT'L. L. COMM'N. 242, U.N. Doc. A/CN.4/SER.A/1966/Add.1.

94 *Id.*

95 *Id.*

> due form by a State organ or agent competent under international law to give that consent.

It is only in those instances "when the violation of internal law regarding competence to conclude treaties would be *objectively evident to any State dealing with the matter normally and in good faith,* [that] the consent to the treaty purported to be given on behalf of the State may be repudiated."[96]

The strictness with which the International Law Commission (ILC) drafted this provision of the Vienna Convention has led at least one writer to conclude that the article's application would be rare.[97] In explaining its recommended approach, the ILC has pointed out that international law "has devised procedures--ratification, acceptance, approval and accession--specifically for the purpose of enabling Governments to reflect fully upon the treaty before deciding whether or not the State should become a party to it, and also of enabling them to take account of any domestic constitutional requirements."[98] Thus, the ILC concluded, the negotiating states, after having gone through these procedures, would have carried out all that can be reasonably expected of them in this matter. For a government to question on constitutional grounds the "internal handling of the treaty by another Government would certainly be regarded as an inadmissible interference" in the latter's affairs.[99]

These observations appear to have equal validity in the case of loan agreements embodied in treaties in view of the notoriety given to restrictions imposed on capacity to contract loans in a number of countries and the usual practice of lending states and multilateral lending institutions to ascertain beforehand, through various means, the restrictions imposed by the internal law of the borrowing state. However, while private creditors have developed procedures for establishing the legal capacity of the borrowing state,[100] they are not the same as those observed in treaty-making, and may be much less strict than the latter.

Questions may be raised as to whether a debtor-state is precluded from invoking its courts' decision--which has retroactive effect--that under the law prevailing when a loan agreement in treaty form was contracted, the state or its representative lacked proper authority or capacity to bind the state. This would have no adverse effects on the validity of the treaty for as long as the other contracting party acted in good faith, and it could establish that the violation was not manifest. For instance, it could be shown that the controversial provision was ambiguously drafted as to

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96 *Id.*

97 T. ELIAS, THE MODERN LAW OF TREATIES 149 (1974).

98 2 Y.B.INT'L. L. COMM'N. 241, U.N. Doc. A/CN.4/SER.A/1966/Add.1.

99 *Id.* at 242.

100 See text accompanying notes 82 to 85, *supra.*

admit of a conclusion that the other party or its representative had the proper authority or capacity. The letter and spirit of Article 46 do not hold the other contracting party responsible for the subsequent interpretation, or changes therein, by municipal courts of difficult municipal law questions relating to the capacity of the state or the authority of state representatives to contract treaties or foreign debts in general.

A related provision to the concept of lack of capacity is Article 47 of the Vienna Convention I which states:[101]

> If the authority of a representative to express the consent of a State to be bound by a particular treaty has been made subject to a specific restriction, his omission to observe that restriction may not be invoked as invalidating the consent expressed by him unless the restriction was notified to the other negotiating States prior to his expressing such consent.

In this particular case, the state imposing a limitation on its representative's capacity to give consent is under a duty to inform the other party of the said restrictions; otherwise, it cannot invoke the above provision in order to avoid its treaty obligations. As distinguished from the situation governed by Article 46, the restrictions in Article 47 are limited "to cases in which the defect of authority relates to the execution of an act by which a representative purports *finally* to establish his State's consent to be bound."[102] Judge Elias has further suggested that Article 47 covers those restrictions provided for in executive instruments or administrative regulations of a kind not otherwise specifically provided for in the fundamental law or statutes since the latter type is adequately provided for in Article 46.[103]

A violation falling under Article 46[104] or 47[105] would not render a treaty *ipso facto* void, but would only give rise to a right to invoke the invalidation of a state's consent. A treaty the invalidity of which is established for violation of Article 46 or 47, is void and has no legal force under the Conventions.[106] However, if acts have nevertheless been performed in reliance on such a treaty, the restoration of the *status quo ante* is required.[107] In a loan agreement contained in a treaty which is

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101 Article 47 of Vienna Convention II contains essentially the same provision.

102 ELIAS, *supra* note 96, at 151.

103 *Id.* at 152.

104 Article 46 (1 and 3) of the Vienna Convention II.

105 Article 47 of the Vienna Convention II.

106 Article 69 of both Conventions.

107 Article 69 (2) of both Conventions provides--"2.If acts have nevertheless been performed in reliance on such a treaty: (a) each party may require any other party to establish as far as possible in their mutual relations the position that would have existed if the acts had not been performed; (b) acts performed in good faith before the invalidity was invoked are not rendered unlawful by reason only of the invalidity of the treaty."

invalidated under Article 46 or 47, this means the return of whatever amounts were received by the borrower-state.

3.2. *Corruption and Fraud*

3.2.1. Under municipal law

The use of bribes on government officials in order to obtain a government contract is punished as a crime in most, if not all, municipal jurisdictions. A contract thus obtained may be treated in municipal law as void *ab initio* , or, at the very least, voidable at the instance of the state. In comparison, the corruption of the officials of a foreign state, as distinguished from officials of the domestic state, might not be considered as criminal although it might give rise to a liability for damages or to other civil remedies. In some jurisdictions, however, such an act is punished as a crime. A good example is the U.S. Foreign Corrupt Practices Act of 1977.[108] This piece of federal legislation makes it unlawful for any issuer which has a class of securities registered under federal law, or any domestic concern, or any officer, director, employee, or agent of such issuer or domestic concern, or any stockholder thereof acting on behalf of such issuer or domestic concern,

> to make use of the mails or any means or instrumentality of interstate commerce corruptly in furtherance of an offer, payment, promise to pay, or authorization of the payment of any money, or offer, gift, promise to give or authorization of the giving of anything of value to--

(1) any foreign official,

(2) any foreign political party or official thereof or any candidate for foreign political office, or

(3) any person, while knowing or having reason to know that all or a portion of such money or thing of value will be offered, given or promised, directly or indirectly, to any foreign official, to any foreign political party or official thereof, or to any candidate for foreign political office,

for purposes of--

> (A) influencing any act or decision of such official in his official capacity, including a decision to fail to perform his official functions; or
>
> (B) inducing such foreign official to use his influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality,

108 U.S. Public Laws 95-213, Title I, Dec. 19, 1977, 91 Stat. 1494-1498 (Title 15, ss 78a note, 78m, 78dd-1, 78dd-2, 78ff).

in order to assist such issuer or domestic concern in obtaining or retaining business for or with, or directing business to, any person.

The fact alone that such acts are made punishable under the criminal laws of the U.S. is an advantage to a sovereign borrower which is in a position to establish by evidence a violation of the FCPA. The private creditor would, under the circumstances, be more open toward renegotiating or forgiving the loan extended; otherwise there would be risk of prosecution under the FCPA.

A sovereign borrower may also invoke the legal effects on the contract by the employment of corruption, but while the FCPA imposes fines on violators,[109] it does not expressly define the legal status of a contract entered into in violation of the FCPA's provisions. In some jurisdictions, a violator of a penal statute may not be allowed to recover what he has given under a contract which he obtained in violation of that statute. However, this is not clear from the FCPA's provisions although the Restatement of the Law of Contracts states that any "bargain is illegal if either the formation or the performance thereof is prohibited by constitution or statute", and that legislative intent to prohibit the formation of a bargain, or an act essential for its performance may be manifested by "... imposing a penalty for the formation of the bargain or for doing an act that is essential for the performance thereof..."[110]

If, under the applicable municipal law, a public official is considered an agent of his government, "(a) person who, without being privileged to do so, intentionally causes or assists an agent to violate a duty to his principal is subject to liability to the principal."[111] Under the Restatement of Contracts, section 570, an agreement between an agent or fiduciary and another party to violate his duties is illegal.[112] A related provision, Section 313 of the Restatement of Agency 2nd, states:[113]

> (1) A person who, knowing that the other party to a transaction has employed an agent to conduct a transaction for him, employs the agent on his own account in such transaction is subject to liability

109 *Id.*, 78ff.

110 2 U. S. RESTATEMENT OF CONTRACTS 1087-1088 (1932). The commentaries on this provision indicate that "The legislature can prohibit the formation of any bargain and thereby make it illegal. The question whether the legislature has done so depends on the interpretation of the legislative action. In case of express prohibition or of declaring the act a crime there can be no doubt. With reference to the imposition of a penalty or the requirement of a license, the rule cannot be so broadly stated. Legislative intent must be sought in each particular case. . ." An illustration of what falls outside the scope of clause (c) is the following: "A marries B. A statute imposes a penalty for contracting a marriage without complying with certain methods. The only consequence of the illegality is the exaction of the statutory penalty."

111 2 U.S. RESTATEMENT (SECOND) OF AGENCY Section 312 (1958).

112 2 U.S. RESTATEMENT OF CONTRACTS 1075 (1932).

113 2 U.S. RESTATEMENT (SECOND) OF AGENCY 52 (1958).

> to the other party, unless he reasonably believes that the other party acquiesces in the double employment.

The comments on Section 313, in turn, state:[114]

> The transaction is fraudulent with respect to the first principal and he is entitled to the remedies given for fraud. He can elect to rescind the transaction; or he can affirm it and recover from the other party the damage caused by the fraud, or at his election, commissions or improper gratuities paid to the agent by the other party.

Thus, the concept of fraud, where applicable, may also be invoked in order to have a loan agreement voided under municipal law.[115]

Writing way back in the 1920s, Sir John Fischer Williams pointed out that the law on trustees may be applicable to sovereign loans since a government is in a fiduciary relationship with the state's citizens.[116] English law, he observed, "has always recognised the peculiar situation of a trustee" and contracts involving a breach of trust cannot be enforced.[117] He noted that Grotius much earlier proposed treating "a guardian as having the powers of an owner when he duly administers, not when he robs his ward."[118] Williams noted further that[119]

> If a loan has been contracted recklessly or with a view to the private profit of those exercising authority and not to the well-being of the State, or if its payment in full would involve a breach of the duty which the State owes to its wards or members, the case may have its analogies in private law.

3.2.2. Under international law

Article 50 of Vienna Convention I contains the following provision on corruption:[120]

> If the expression of a State's consent to be bound by a treaty has been procured through the corruption of its representative directly or indirectly by another negotiating State, the State may invoke such corruption as invalidating its consent to be bound by the treaty.

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114 *Id.* at 53.

115 In the American Law Institute's Restatement of the Law of Contracts, fraud generally means "(a) misrepresentation known to be such, or (b) concealment, or (c) non-disclosure where it is not privileged, by any person intending or expecting thereby to cause a mistake by another to exist or to continue, in order to induce the latter into or refrain from entering into a transaction..." Section 471, RESTATEMENT OF THE LAW OF CONTRACTS 891-892 (1932).

116 J. WILLIAMS, CHAPTERS ON CURRENT INTERNATIONAL LAW AND THE LEAGUE OF NATIONS 325 (1929).

117 *Id.*

118 *Id.*

119 *Id.*

120 The parallel provision is found in Article 50 of the Vienna Convention II.

This article contemplates a situation wherein the representative of a state is offered inducements of varied kinds by the other state in order to act in accordance with the interests of the latter state, and excludes "ordinary civilities and normal exchanges incident to legitimate diplomatic intercourse."[121] The phrase "directly or indirectly" reflects the ILC's appreciation of the fact that if corruption by another state occurs, it is unlikely to be overt.[122] However, the ILC also considered that "in order to be a ground for invalidating the treaty, the corrupt acts must be shown to be directly or indirectly imputable to the other negotiating State."[123]

The provision on corruption does not cover cases of inducements given by one state, not to the representative of the other state but, to government officials from whom that representative takes orders. It is arguable whether such cases would fall under the article on fraud which is general enough to embrace various forms of "fraudulent conduct." According to the ILC, the latter expression "is designed to include any false statements, misrepresentations or other deceitful proceedings by which a State is induced to give a consent to a treaty which it would not otherwise have given."[124]

Article 49 of the Vienna Convention I[125] provides thus with respect to fraud:

> If a State has been induced to conclude a treaty by the fraudulent conduct of another negotiating State, the State may invoke the fraud as invalidating its consent to be bound by the treaty.

While admitting that in international law, "the paucity of precedents means that there is little guidance to be found either in practice or in the jurisprudence of international tribunals as to the scope to be given to this concept,"[126] the International Law Commission felt that "it would suffice to formulate the general concept of fraud applicable in the law of treaties and to leave its precise scope to be worked out in practice and in the decisions of international tribunals."[127] This article applies whenever fraud was employed by one contracting state on another to enter into a loan agreement. The incentives for the employment of fraud by the lending party may not necessarily accrue to the benefit of the lending state but to individuals who represent it; the fraud in that case, however, is imputable to the state itself.

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121 ELIAS, *supra* note 96, at 166.

122 2 Y.B.INT'L. L. COMM'N. 245, U.N. Doc. A/CN.4/SER.A/1966/Add.1.

123 *Id.*

124 *Id.*

125 Article 49 of Vienna Convention II essentially provides for the same.

126 2 Y.B.INT'L. L. COMM'N. 244, U.N. Doc. A/CN.4/SER.A/1966/Add.1.

127 *Id.*

Article 49, though, does not appear to cover cases where the fraud was employed by private nationals of one of the contracting parties on the other, unless those private persons were acting on behalf of or in collusion with the officials of the first contracting state.

Each of the grounds cited above has the same legal effect on the validity of the treaty: they do not render the treaty *ipso facto* void; they only entitle the injured party, if it wishes, to invoke fraud or corruption as invalidating its consent. Unlike cases involving the state's lack of capacity, however, a significant feature of the Vienna Conventions' approach is that the party to which the fraud or the act of corruption is imputable does not have the right, "for obvious reasons,"[128] to require the innocent party "to establish as far as possible in their mutual relations the position that would have existed if the acts had not been performed."[129]

In cases involving fraud or corruption, the Vienna Convention I states that "the State entitled to invoke the fraud or corruption may do so with respect either to the whole treaty, or subject to paragraph 3, to the particular clauses alone,"[130] although in the latter case, corruption or fraud may be invoked only with respect to those clauses where:[131]

> (a) the said clauses are separable from the remainder of the treaty with regard to their application;
>
> (b) it appears from the treaty or is otherwise established that acceptance of those clauses was not an essential basis of the consent of the other party or parties to be bound by the treaty as a whole; and
>
> (c) continued performance of the remainder of the treaty would not be unjust.

The rule on the separability of treaty provisions is, therefore, different for cases involving fraud or corruption from cases involving other grounds. As the ILC commentary clarifies,[132] Article 44(4)

> ...while still making the question of the separability of the clauses subject to the conditions contained in paragraph 3, lays down a different rule for cases of fraud...and corruption...In these cases the ground of invalidity may, of course, be invoked only by the State which was the victim of the fraud or corruption, and the Commission considered that it should have the *option* either to invalidate the whole treaty or the particular clauses to which the fraud or corruption related.(emphasis supplied)

128 2 Y.B.INT'L. L. COMM'N. 265, U.N. Doc. A/CN.4/SER.A/1966/Add.1.

129 Article 69 of both Conventions provides: "(3) In cases falling under articles 49, 50, 51 or 52, paragraph 2 does not apply with respect to the party to which the fraud, the act of corruption or the coercion is imputable."

130 Paragraph 4 of Art. 44, dealing with the separability of treaty provisions, of both Conventions.

131 Article 44 (3) of both Conventions.

132 2 Y.B.INT'L. L. COMM'N. 238, U.N. Doc. A/CN.4/SER.A/1966/Add.1.

3.3. *Other possible grounds and legal issues*

3.3.1. Non-observance of formalities, coercion, and error

Even in international law, there may be formal requirements which have to be observed. Thus, Article 102 of the United Nations Charter requires the registration with its secretariat of every treaty and international agreement entered into by any of its members; failure to register deprives any party to such treaty or international agreement of the right to invoke it before any organ of the U.N.[133] In municipal law, there are also formal requirements which are often imposed in order to render a particular type of agreement valid or enforceable. Realistically, though, since sovereign-debtor loans usually involve sizable sums, the probability of formal requirements having been missed seems remote.

On the other hand, a treaty is considered *ipso facto* void if its conclusion has been procured by "the threat or use of force in violation of the principles of international law embodied in the Charter of the United Nations."[134] The same rule applies where "the expression of a state's consent to be bound by a treaty which has been procured by the coercion of its representative through acts or threats directed against him shall be without any legal effect."[135] It is rather hard to conceive of instances when a state will resort to the coercion of another state or its representative in order to force the latter to contract debt agreements with it. It is even harder to visualize cases where the threat or use of force is confined to "armed" force. Although proposals to include economic or political pressure in the text of Article 52 did not push through in the Convention, "a declaration condemning the threat or use of pressure in any form by a State to coerce any other State to conclude a treaty"[136] was adopted, and the interpretation that is to be given to the term "use of force" is bound to affect the interpretation of the same phrase in the Vienna Convention.

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133 Article 102, paragraphs 1 and 2, U.N. Charter. Volume 859 of the U.N.T.S. contains the following historical note: "On 14 December 1946 the General Assembly of the United Nations, by resolution 97(I), adopted regulations to give effect to Article 102 of the Charter of the United Nations. The text of resolution 97(I) was published by the Secretariat in the first volume of the United Nations *Treaty Series* (pages XX to XXVIII). The regulations were later modified by resolutions 364 B(IV) and 482(V), adopted by the General Assemby on 1 December 1949 and 12 December 1950, respectively. The text of these resolutions was likewise published in *Treaty Series* volumes 44 (page XII) and 76 (page XVIII). Further modifications were introduced in the regulations by resolution 33/141 A, adopted by the General Assembly on 19 December 1978."

134 Article 52 of Vienna Conventions I and II.

135 Article 51 of Vienna Conventions I and II. The ILC concluded that "the use of coercion against the representative of a State for the purpose of procuring the conclusion of a treaty would be a matter of such gravity that the article should provide for the absolute nullity of a consent to a treaty so obtained." 2 Y.B. INT'L. L. COMM'N. 246, U.N. Doc. A/CN.4/SER.A/1966/Add.1.

136 ELIAS, *supra* note 97, at 174.

The use of economic, political or military pressure in loan agreements, however, appears remote, unless, perhaps, the coercing state desires to have new treaties reaffirming previously contracted ones which suffered from some legal defect or political stain. However, notwithstanding the rarity of its application in international law, the treatment of coercion in international law may have some instructive value which municipal law tribunals can consider.

Where coercion is available as a ground under the above discussed provisions, there is no obligation on the part of the innocent sovereign borrower to return what has been received under the loan agreement embodied in a treaty.[137]

Error in treaties and its legal effects are addressed in Article 48 of the Vienna Convention I[138]:

> 1. A State may invoke an error in a treaty as invalidating its consent to be bound by the treaty if the error relates to a fact or situation which was assumed by that State to exist at the time when the treaty was concluded and formed an essential basis of its consent to be bound by the treaty.

The common errors in international treaties are geographical ones involving maps and boundaries,[139] and exclude errors relating only to the wording of the text of the treaty.[140] Thus, the article is not applicable to errors in the text as to the amount of the prinicipal or the interest in a loan agreement embodied in a treaty; instead, Article 79 of the Convention on the correction of errors in the text of the treaty will apply and the validity of the treaty will remain unaffected.[141] An error, however, cannot be invoked by a state if it contributed by its own conduct to the error or if the circumstances were such as to put the state on notice of a possible error.[142]

However, where Article 48 is applicable, it gives rise to an obligation on the part of the parties to the treaty to restore the *status quo ante* by returning whatever has been received thereunder.[143] The Convention does not distinguish between an error made by only one party and that made by both or all parties, "so long as the error relates to a fact or situation assumed by the party invoking it as in existence at the time of the conclusion of the treaty."[144] If one party knew of an error but had made

137 Article 69 (3) of Vienna Conventions I and II.

138 Article 48 of Vienna Convention II is the parallel provision.

139 2 Y.B.INT'L. L. COMM'N. 243, U.N. Doc. A/CN.4/SER.A/1966/Add.1.

140 Article 48(3) of Vienna Conventions I and II.

141 Article 79 of Vienna Convention II is the parallel provision.

142 Article 48(2) of Vienna Conventions I and II.

143 Article 69 (2) of Vienna Conventions I and II.

144 ELIAS, *supra* note 97, at 244.

fraudulent misrepresentations regarding it which induced the other to enter into the treaty, then this would constitute fraud.[145]

Error has not been frequently invoked in international fora as an element vitiating state consent.[146] The lengthy and complex process involved in treaty-making appears to have reduced the incidence of errors.[147] The rule, however, might just find some application with respect to loan agreements. Although Article 48 says "error in a treaty", the error contemplated is any error *relating* to "a fact or situation assumed by the party invoking it as in existence at the time of the conclusion of the treaty" and constituting "an essential basis of the consent of that party to be bound."[148]

3.3.2. Project or tied loans

Loans extended for specific projects or loans intended for the procurement of goods or services from the lender or from nationals of the lender-state deserve a separate discussion as they involve unique features which determine the grounds for selective disengagement relating to the contracting of the loan agreement that can be invoked by a sovereign debtor.

Project loans have been described as the "most tractable, most welcome by LDC borrowers in principle, and usually the least onerous."[149] They are presumed to be[150]

> self-liquidating, since...Repayment conditions are stipulated to coincide with, indeed to lag slightly behind, the project schedule of execution... Therefore, it is assumed that projects generate the resources required to amortize the loan that has financed their execution.

The purpose clause in loan agreements covering such projects indicates the purpose for which the loan was extended. Thus, so-called *economic infrastructure loans*, "possibly self-liquidating, are usually project loans that finance construction, expansion and modernization of airports, subways, railroads, port facilities, and such sophisticated innovations as microwave and other telecommunications projects and atomic energy facilities."[151] *Economic and social infrastructure loans*, on the other hand,

145 *Id.* at 132.

146 *Id.* at 154.

147 *Id.*

148 *Id.* at 157.

149 J. Epstein, *supra* note 3, at 60.

150 *Id.* This would be true for non-recourse project financing.

151 A. Adede, *Loan Agreements Between Developing Countries and Foreign Commercial Banks--Reflections on Some Legal and Economic Issues*, 5 SYR. J. INT'L. L. & COM. 235 (1978) 259 at footnote 88, citing Greene, *Financing Foreign Government and Official Entities* in OFF-SHORE LENDING BY U.S. COMMERCIAL BANKS 187, 206 (F. Mathis ed. 1975).

though "not directly self-liquidating, are also usually project loans for such purposes as the construction, expansion and modernization of highways, sewer systems, multi-purpose dams, water supply systems and bridges,"[152] while *general social welfare loans* normally "are project loans and finance construction of, for example, schools, health facilities and low-cost housing."[153]

Let us now consider the specific application of a ground for the invalidation of a treaty. Consider the case of a loan agreement embodied in a treaty providing for the extension of a loan by one state to another state which is tied to the sale of goods or services from the former to the latter. If there is error in the determination of the suitability of the goods or services to the purpose contemplated, and the error is material to the loan agreement such that the other party would not have assumed obligations under the agreement if the real facts had been known before ratification, would such party be bound by the treaty? More specifically, in a project loan covered by a treaty where an error is committed by a party other than the borrowing state in the calculation of the capacity of the factory (whose production is the contemplated source for the repayment of the loan) bought with the proceeds of the loan from a seller who is a national of the lending state as specified in the agreement and the error is such as would render the operation of the machinery economically unfeasible, would this be a proper ground for the invocation of error under the Vienna Conventions?

A crucial issue, it appears, is whether the sale is related to the treaty or not. Where the treaty itself provides for the terms of the sale of the goods, there is more solid ground for the contention that the required nexus between the treaty and the error exists. Where the text of the treaty does not incorporate the terms of the sale--which is true in almost every case--although the treaty requires the application of the proceeds of the loan to such a sale, there is room for the view that the sale is an entirely separate transaction, and any error related to the sales contract cannot be invoked as a ground for invalidating the treaty. If this approach is to be followed, the remedy of the borrowing state is against the private seller, but its obligation to repay the loan subsists in accordance with the original terms of the treaty. In effect, this would mean that under the Convention, if the factory fails to function as planned due to an error in the computation of its capacity, the period for repayment of the loan is not interrupted; the borrower, however, if any remedy is available to it, can run against the seller.

152 *Id.* Epstein, *supra* note 3, at 60, points out that by 1987, nonproject debt accounted for 56 percent of LDC debt including over $500,000 million dollars owed to commercial banks. In individual countries, particularly the newly industrialized ones, "the proportion of nonproject debt reached as much as 70 percent of the total". In the early 70s, commercial bank credit accounted for only one-third of the total LDC debt.

153 Adede, *supra* note 151, at 260.

The contrary view, however, would maintain that the error concerns a fact or situation related to the treaty. It can be argued that the intent of the borrower was to borrow if and only if the object which was to be purchased with the proceeds of the loan were of a certain quality and that of the lender was to lend if and only if the proceeds of the loan were to be used in a transaction specified in the treaty. The fact that the lending country usually requires that the transaction between the borrowing country and the private seller be submitted for the lending country's approval prior to the release of the proceeds of the loan may also strengthen the borrower's position that the error has such material relation to the treaty that it can be invoked as a ground for the treaty's invalidation. The prior approval rule can also be used to counter the objection that the error of the seller cannot be attributed to the lending state.

A possible defense on the part of the lender, that a state cannot invoke error as a ground if it contributed by its own conduct to the error or if the circumstances were such as to put the state on notice of a possible error, may not be applicable in cases like that presented above, particularly in loan agreements tied to the sale of a factory or high technology equipment. The borrower-state, particularly an LDC, may not exactly be in the best position to determine if an error relating to the goods sold existed or not.

The law of treaties provision constituting fraud as a ground for invalidating a treaty, however, does not convert the lender into an absolute insurer of the economic feasibility of the project for which it extended a loan. For as long as the project complies with the standards contemplated by the parties, the disappearance of a profitable market for the products of the factory purchased under the loan does not give rise to a ground for the termination of the treaty, although an error in good faith may have been made in assessing the future market for the goods--unless the lender has warranted the continuous availability of such a market.

Where error is applicable, however, each party to a treaty which is invalidated on the ground of error can require the other to return what it has received under the agreement, to be carried out "as far as possible".[154] Where a project was constructed but has been rendered unproductive due to error, the borrower-state can argue that, consistent with the foregoing rule, the lender is free to remove whatever was constructed with the loan that was extended.

The existence or non-existence of a legal link between the loan transaction and the sale will just be as crucial in cases involving graft and corruption. Although the sale transaction may have been tainted by graft and corruption, this circumstance may result at most in the invalidation of the sale but not of the loan if the latter transaction remains untainted. Of

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154 Article 69(2) of Vienna Conventions I and II.

course, where collusion between the creditors and the sellers is established, the validity of the loan itself may not be spared from challenge.

Project financing extended by private law persons may be approached in a manner similar to that indicated in the preceding discussion.

3.3.3. Effects of rescheduling agreements and estoppel

Under the Vienna Conventions,[155] a state can no longer invoke

> a ground for invalidating, in terminating, withdrawing from or suspending the operation of a treaty under articles 46 to 50 or articles 60 and 62 if, after becoming aware of the facts:
>
> (a) it shall have expressly agreed that the treaty is valid or remains in force or continues in operation, as the case may be; or
>
> (b) it must, by reason of its conduct, be considered as having acquiesced in the validity of the treaty or in its maintenance in force or in operation, as the case may be.

This provision forecloses a state from invoking a ground under the Conventions, if there was an express recognition of the agreement's validity or such recognition can be implied from the state's conduct. The said provision applies when the ground invoked is corruption, fraud, violation of internal law regarding competence to conclude treaties, or error, but not where the ground is coercion of a representative of a state or coercion of a state by the threat or use of force.

Would a restructuring agreement fall under the scope of the rule quoted above? A restructuring may result in the imposition of a uniform agreement for all debts to be restructured.[156] "This restructuring agreement then replaces and supercedes for legal purposes the individual credit instruments under which the debt was originally contracted (at least for those maturities being restructured)."[157] On the other hand, the existing agreements covering the debts to be restructured "may be preserved with appropriate adjustments to applicable maturities, interest rates and fees."[158] In this latter case, the original instruments or agreements evidencing debts to be restructured have to be dealt with on an individual basis.[159]

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155 Article 45 of Vienna Conventions I and II.

156 M. Walker and C. Buchheit, "Legal Issues in the Restructuring of Commercial Bank Loans to Sovereign Borrowers" in SOVEREIGN LENDING : MANAGING LEGAL RISK 143 (Gruson, Reisner, eds. 1984).

157 *Id.*

158 *Id.*

159 *Id.* at 18 to 19.

However, for the rule to apply against a state that has entered into a restructuring agreement, the type of restructuring is not the determining factor. A rescheduling agreement need not have the effect of preventing a state from raising any ground for the invalidity of a loan agreement unless it was aware, at the time of entering into the rescheduling agreement, of the existence of the grounds for invalidity. Where, however, the state was aware of such grounds, and nevertheless chose to restructure either through a replacement of the defective agreements with a new one or only an amendment of certain provisions of the agreements covering the debts to be restructured, such conduct may be considered as acquiescence in the validity of the treaty. However, if there were accompanying statements that may have reserved the state's right to invoke the grounds at a later time, and provided there was no express statement by the state entitled to invoke the grounds that the treaty is valid, then the loss of such right to invoke a ground for invalidation cannot be implied from the conduct of the state.

To proceed to another issue, can it be argued, in cases where the party invoking any of the above grounds for the invalidation of a treaty was aware of such circumstances at the time that the loan agreement was contracted, that such party is precluded from later on invoking that ground? It is clear that this would be the result in cases involving an error.[160] However, it is submitted, that the result would be different in cases involving fraud or corruption. Although the acts of state officials may be imputable to the state, this rule on state responsibility is not applied to a case where the representative of the state is corrupted. In the same vein, it cannot be applied to a case where state officials other than the state representative in the treaty negotiations have been corrupted. That the officials of the contracting state were parties to the fraud or corruption, or even if they had in fact actively solicited the giving of inducements, would not prevent the injured party from invoking either of these grounds.

3.3.4. Procedural issues

The procedure laid down in the Vienna Conventions[161] forestalls unilateral action on the part of any state. Under Articles 65 and 66 of Vienna Convention I, a state invoking any of the grounds for the invalidation of a treaty, other than a conflict with a peremptory norm of general international law, will need the consent of the other party to the treaty. In case there is an objection by the other party, the parties are required to settle their dispute peacefully in accordance with Article 33 of the U.N. Charter.[162] If no solution is reached within twelve months from the date on which the objection was raised, any of the parties may resort to

[160] *See* Article 48(2) of Vienna Conventions I and II.

[161] While the procedure laid down in Article 66 of Vienna Convention II and its Annex differs in a number of respects from the procedure in Vienna Convention I and its Annex, the two Conventions do not differ with respect to the rule that consent of the other party is necessary in order to invoke a ground for the invalidation of a treaty.

[162] Article 65(3) of both Conventions.

the procedure laid down in the Annex to the Convention by submitting a request to that effect with the U.N. Secretary-General.[163] The Conciliation Commission constituted by the Secretary-General in accordance with the Annex is required to render a report, but the report including the Commission's conclusions regarding facts and questions of law are not binding on the parties, and "shall have no other character than that of recommendations submitted for the consideration of the parties in order to facilitate an amicable settlement of the dispute."[164]

Consistent with that approach, and on the basis of the requirement that the principle of good faith must be observed, it has been suggested that a state cannot unilaterally act to suspend performance under a loan agreement which is alleged to be defective, "even in the case of possibly corrupt transactions."[165]

A contrary view, however, has been expressed in the Harvard Research draft convention on the law of treaties which provides that, if the effect of the invalidating cause is to render the treaty void, then the innocent state can, pending determination, unilaterally suspend performance on its part.[166] Paragraphs b and c of Articles 27, 28, 29, and 31 of the draft state:[167]

> b. Pending agreement by the parties upon and decision by a competent tribunal or authority, the party which seeks such a declaration may provisionally suspend performance of its obligation under the treaty.
>
> c. A provisional suspension of performance by the party seeking such a declaration will not be justified definitively until a decision to this effect has been rendered by the competent international tribunal or authority.

Explaining the approach it adopted, the Harvard Research stated:

> ...in view of the further fact that continued performance of its obligations under a treaty *vis-a-vis* a State charged with breach thereof might prove costly or even involve irreparable damage to the State seeking the declaration, if the decision is ultimately in its favor, it seems only reasonable to permit the latter state to suspend its obligations under the treaty *vis-a-vis* the State charged with failure pending agreement upon a competent international tribunal or authority, and pending final decision by such authority.

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163 Article 66(b) of Vienna Convention I.

164 Item number 6 of the Annex to the Vienna Convention I.

165 F. Feliciano, "Some Reflections on the Current Approach to International Debt Management" (1987).

166 Harvard Research draft convention on the law of treaties Supplement to 29 AM. J. INT'L. L. 1094, 1096, 1126, 1144 (1935).

167 *Id.*

The draft commentaries do state, however, that section (c) quoted above

> ...stands as a warning to States that they are not lightly to accuse other States of failing to fulfill their treaty obligations and then to proceed not to fulfill their own with respect to such States...If...its contentions are not substantiated by proof and are not sustained by the international tribunal or authority, the latter, of course, will deny the declaration sought. And in such case, the unilateral suspension of performance of its obligations under the treaty *vis-a-vis* the State which it erroneously alleged to have violated the treaty will result in putting the suspending State itself in the position of a party which wrongfully failed to carry out its treaty obligations in accordance with the rule *pacta sunt servanda.*

Unilateral suspension of performance *per se*, therefore, is not perceived as violative of the rule that treaties must be observed in good faith. Thus, there is nothing to prevent the recognition of its validity by a municipal law tribunal especially if the municipal law which is applicable to the loan agreement allows such a remedy on the part of the party invoking the defect.

The right of the innocent state to resort to unilateral action subject to final determination by arbitrators or tribunals or the agreement of the parties appears to have been recognized in the case of 95 million U.S. dollars worth of debts incurred by the Nkrumah government to four British companies.[168] Independent experts estimated that the goods and services supplied to Ghana were only 70-75% of the actual value of the contracts.[169] The Acheampong government which succeeded Nkrumah's regime unilaterally repudiated in 1972, on the ground of corruption, the debts owed to private companies but guaranteed by the British government. After a series of negotiations where both the IMF and the World Bank took part, the parties agreed to a compromise which expressly recognized the right of Ghana to refuse payment on at least part of the credit contracts if, as a result of arbitration, these were proven to have been obtained through bribery and corruption.[170] The government of Ghana, however, did not

168 C. Prout, *Finance for Developing Countries: An Essay* in INTERNATIONAL ECONOMIC RELATIONS 360, 391 *et. seq.* specially at 400.

169 *See* A. KRASSOWSKI, DEVELOPMENT AND DEBT TRAP: ECONOMIC PLANNING AND EXTERNAL BORROWING IN GHANA (1974); *also cited* in KORNER, MAASS, et. al., THE IMF AND THE DEBT CRISIS 121 (1986).

170 The treaty between Ghana and Great Britain did not expressly refer to the right of repudiation of Ghana. It only referred to this indirectly by stating thus: "Desiring to conclude an Agreement to give effect to the proposals formulated at the conference held in Ghana from 11 to 18 December 1973 and in Italy from 11 to 13 March 1974 at which the Government of the United Kingdom and the Government of Ghana, together with certain other governments, the International Monetary Fund and the International Bank for Reconstruction and Development were represented." (1975 Gr. Brit. T.S. No. 66.) For the terms of the compromise, see the "Agreed Minute of the Rearrangement of Medium Term Debt Repayment due from Ghana between July 1970 and June 1972", London, 12 July

seek an application of this provision. More significantly, although Ghana agreed to repay the interest incurred prior to its repudiation, the interest for the subsequent period was waived.

4. GROUNDS FOR DISENGAGEMENT RELATING TO THE PERFORMANCE OF LOAN AGREEMENTS

4.1 State of Necessity and Force Majeure

4.1.1 *Force majeure*

Force majeure is a phrase that has been invoked and recognized in a number of disputes decided by international tribunals, in state practice as reflected in treaties and diplomatic and other official papers, as well as in the writings of specialists, as a ground for precluding the wrongfulness of an act of a state.[171] The potpourri of concepts to which the phrase was applied, however, was not clearly segregated and systematically delineated until the International Law Commission's work on the draft articles on state responsibility was under way.

Largely through the efforts of its Special Rapporteur, Mr. Roberto Ago, the ILC distinguished between the instances properly falling within the concept of *force majeure* and "fortuitous event", on the one hand, and "state of necessity", on the other, as circumstances precluding wrongfulness. The first set of concepts is now contained in Article 31 (of the draft articles on state responsibility) which runs as follows:

> Article 31. *Force majeure* and fortuitous event
>
> 1. The wrongfulness of an act of a State not in conformity with an international obligation of that State is precluded if the act was due to an irresistible force or to an unforeseen external event beyond its control which made it materially impossible for the State to act in conformity with that obligation or to know that its conduct was not in conformity with that obligation.
>
> 2. Paragraph 1 shall not apply if the State in question has contributed to the occurrence of the situation of material impossibility.

1970; and the "Agreed Minute on the Repayment of the Medium-Term Debt of the Government of Ghana and Others Resident in Ghana", Rome, 13 March 1974.

171 U.N. Document A/CN.4/315 is a study prepared by the Secretariat on *"Force majeure" and "fortuitous event" as circumstances precluding wrongfulness: survey of State practice, international judicial decisions and doctrine.* Reprinted in 2 Y.B. INT'L. L. COMM'N. 61, U.N. Doc. A/CN.4/SER.A/1978/Add.1 (Part 1). This survey, however, does not contain the analysis made by the Special Rapporteur which distinguished *force majeure* proper from other legal grounds to which the phrase had been applied.

The rule as thus formulated expresses the ILC's conclusion, based on the survey which it undertook, that in international law[172]

> there is a well-established and unanimously recognized principle that an act of the State not in conformity with what would otherwise be required of it by an international obligation does not constitute an internationally wrongful act of that State if, as a result of a situation of *force majeure* or fortuitous event, the State is in a position of material impossibility of acting otherwise or of realizing that it is not acting in conformity with the obligation.

For purposes of determining the existence of *force majeure* or fortuitous event, the consent or prior conduct of the state against which an act sought to be justified by *force majeure* or fortuitous event is irrelevant.[173] In that sense, these two concepts differ from "consent"[174] and "countermeasures in respect of an internationally wrongful act"[175] as circumstances precluding the wrongfulness of an act of the state since the latter are determined in reference to the prior conduct or consent of the state subjected to the act sought to be justified.

The conduct involved in cases where *force majeure* and fortuitous event are properly invoked is involuntary or, at least, unintentional.[176] What impels the state's conduct is either an "irresistible force or an unforeseen external event against which it has no remedy and which makes it 'materially impossible' to act in conformity with the obligation or even at times, to be aware of the fact that it is adopting conduct different from that required of the obligation."[177] That differentiation made by the ILC between *force majeure* and fortuitous event, taken together, from other circumstances precluding wrongfulness also incorporates the distinctions between *force majeure* and fortuitous event themselves without preventing legal science from continuing "the analysis with a view to distinguishing between the notions covered by the two terms..."[178]

Article 31, therefore, embodies the two cases of material impossibility covered by either *force majeure* or fortuitous event: the material impossibility of *acting* in a manner consistent with international law, and the impossibility of *knowing* that the conduct adopted was not that required by the obligation.[179] The Article also embodies the two

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172 2 Y.B. INT'L. L. COMM'N. 132, U.N. Doc. A/CN.4/SER.A/1979/Add.1 (Part 2).

173 The ILC's commentary states: "The State subjected to an act committed in these conditions is not involved; it has neither given its consent to the commission of the act nor previously engaged in conduct which constitutes an international offence." 2 Y.B. INT'L. L. COMM'N. 122, U.N. Doc. A/CN.4/SER.A/1979/Add.1 (Part 2).

174 Article 29 of the draft articles.

175 Article 30 of the draft articles.

176 2 Y.B. INT'L. L. COMM'N. 123, U.N. Doc. A/CN.4/SER.A/1979/Add.1 (Part 2).

177 *Id.*

178 *Id.*

179 *Id.*

causes which may give rise to the impossibility: an *irresistible force* or *constraint*, and an *unforeseen external event*.[180] Such force or event may be due to *nature* or to *human action*, and prevents the state, *temporarily* or *definitively*, from honoring an obligation to *act* or *not to act*.[181] But neither *force majeure* nor fortuitous event can be invoked by a state which has contributed, intentionally or through negligence, to the occurrence of the situation of material impossibility.[182]

While there are several cases involving foreign sovereign debts where the courts employed the phrase *force majeure*, the ones which properly fall within the scope of the concept are the *Serbian*[183] and *Brazilian*[184] loans cases involving debtor-states and private creditors whose cause was taken up by France. In the *Serbian Loans* case, Serbia contended that the grave economic consequence of the war affected the legal obligations of the contracts between the Serbian Government and French bondholders. The Court, however, said that "the economic dislocations caused by the war did not release the debtor State, although they may present equities which doubtless will receive appropriate consideration in the negotiations and--if resorted to--the arbitral determination for which Article II of the Special Agreement provides."[185]

On Serbia's contention that "under the operation of the forced currency regime of France, pursuant to the law of August 5th, 1914, payment in gold francs, that is, in specie, became impossible,"[186] the Court noted that if the loan contracts were to be interpreted as referring to the gold franc "as a standard of value, payments of the equivalent amounts of francs, calculated on that basis, could still be made."[187]

To emphasize its point, the Court adverted to the effect of the non-availability of gold coins *in specie* for purposes of discharging the obligations of states parties to the Treaty of Versailles, noting that:[188]

> ...it could hardly be said that for this reason the obligation of the Treaty was discharged in this respect on the ground of impossibility of performance. That is the case of a treaty between States, and this is a case between a State and private persons or lenders. But viewing the question, not as one of the source or basis of the original

180 *Id.*

181 *Id.* at 123-124.

182 Art. 31 (2).

183 *Case Concerning the Payment of Various Serbian Loans Issued in France*, 1929 P.C.I.J. (ser. A) Nos. 20/21 5.

184 *Case Concerning the Payment in Gold of the Brazilian Federal Loans Issued in France*, 1929 P.C.I.J. (ser. A) Nos. 20/21 93.

185 *Case Concerning the Payment of Various Serbian Loans Issued in France*, 1929 P.C.I.J. (ser. A) Nos. 20/21 39-40.

186 *Id.* at 40.

187 *Id.*

188 *Id.*

> obligation, but as one of impossibility of performance, it appears to be quite as impossible to obtain "gold francs" of the sort stipulated in Article 262 of the Treaty of Versailles as it is to obtain gold francs of the sort deemed to be required by the Serbian loan contracts.

As the ILC has pointed out, the Court above "implicitly acknowledged that if the obligation to pay 'in specie' had been explicitly stipulated, there would have been a genuine material and absolute impossibility of performance, and in that case non-performance could not have constituted a breach of obligation."[189] The ILC also noted that the Court treated *force majeure* "as a general principle valid in relation to any system of law, and not as a principle established by a specific internal legal order."[190]

In the related *Brazilian federal loans* case, the court pointed out that the economic dislocation caused by the war "has not, in legal principle, released the Brazilian Government from its obligations."[191] It also concluded that as for the Brazilian claim that the payment should be made in paper francs due to non-availability of gold francs, "there is no impossibility because of inability to obtain gold coins, if the promise be regarded as one for the payment of gold value. The equivalent in gold value is obtainable."[192] The ILC points out, however, that the Court did not thereby deny the applicability of the rule that an absolute impossibility may preclude the wrongfulness of an act of a state.[193] Indeed, as in the *Serbian* loans case, the Court's statements constitute, at the minimum, some kind of acknowledgment of the rule.

4.1.2 *State of necessity*

The concept of state of necessity, as differentiated from the proper scope of *force majeure*, is embodied in the draft articles on state responsibility in the following provision:[194]

> 1. A state of necessity may not be invoked by a State as a ground for precluding the wrongfulness of an act of that State not in conformity with an obligation of the State unless:
>
> (a) the act was the only means of safeguarding an essential interest of the State against a grave and imminent peril; and
>
> (b) the act did not seriously impair an essential interest of the State towards which the obligation existed.

189 2 Y.B. INT'L. L. COMM'N. 128, U.N. Doc. A/CN.4/SER.A/1979/Add.1 (Part 2).
190 *Id.* at note 647.
191 1929 P.C.I.J. (ser. A) Nos. 20/21 120.
192 *Id.*
193 2 Y.B. INT'L. L. COMM'N. 128, U.N. Doc. A/CN.4/SER.A/1979/Add.1 (Part 2).
194 Article 33 of the draft articles.

2. In any case, a state of necessity may not be invoked by a State as a ground for precluding wrongfulness:

(a) if the international obligation with which the act of the State is not in conformity arises out of a peremptory norm of general international law; or

(b) if the international obligation with which the act of the State is not in conformity is laid down by a treaty which, explicitly or implicitly, excludes the possibility of invoking the state of necessity with respect to that obligation; or

(c) if the State in question has contributed to the occurrence of the state of necessity.

Like *force majeure* and fortuitous event, "state of necessity" as a circumstance precluding wrongfulness does not take into account the prior conduct or consent of the state acted against,[195] and the conduct of the state invoking the circumstance must have been induced by an external factor.[196] However, unlike *force majeure* and fortuitous event, the conduct involved in state of necessity is, by nature, deliberate. The situation of extreme peril consists of a grave danger--not merely to a state organ or representative as in "distress" embodied in Article 32 of the draft--but, to the state itself--"to its political or economic survival, the maintenance of conditions in which its essential services can function, the keeping of its internal peace, the survival of part of its population...and so on."[197] The cause in state of necessity is thus not confined to material impossibility but includes a grave danger to a vital interest of the state. The draft provision on state of necessity covers situations involving a relative impossibility to perform the obligation and accordingly fills in a gap created by confining the concept of *force majeure* to cases involving material impossibility.[198]

The proposed draft of Article 33 is phrased negatively, following the approach taken in Article 62 of the Vienna Convention on the Law of Treaties, in order to stress the exceptional character of the rule.[199] A

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195 2 Y.B. INT'L. L. COMM'N. 34, U.N. Doc. A/CN.4/SER.A/1980/Add.1 (Part 2).

196 *Id.*

197 *Id.* at 34-35.

198 1 Y.B. INT'L. L. COMM'N. 176 at paragraphs 24 and 25, U.N. Doc.A/CN.4/SER.A/1980. Mr. Barboza, a member of the ILC also noted that" ...the Commission had agreed to an article on a particular instance of state of necessity, namely, the necessity of an organ of the State provided for in Article 32, concerning distress...Article 33 therefore...acted as a counterpart to Article 32. Since the commission had accepted the principle of necessity in the case of an organ of the state, there was no reason for it to reject the principle of necessity in the case of the state itself." (*Id.*)

199 According to the Commission, it "did not overlook the importance of the fact that, unlike ...the State in regard to which a state of necessity is invoked as a justification for non-fulfilment of an international obligation may be, and often is, in the case in point, an entirely innocent State; that...the State has never given its consent to the act committed in regard to it; and that...the conduct which a State aims to justify on the ground

significant limitation is found in the qualification that a state must not have contributed to the occurrence of the state of necessity. There are questions on whether this provision precludes a state from invoking this circumstance if it contributed to an extreme financial difficulty by, for example, pursuing a lax financial policy.[200]

Among the judicial decisions which the ILC cited as exemplifying state of necessity in cases involving international financial obligations was the *Russian Indemnity*[201] case. In that case, the principle of state of necessity, under the umbrella phrase of *force majeure,* was invoked. Under the terms of the treaty of peace signed on 8 February 1879 which put an end to hostilities between Russia and Turkey, the latter undertook to indemnify the former for the cost of the war and the losses that Russia, including its subjects, suffered.[202] It took twenty years for Turkey to liquidate payments corresponding to claims made by nationals of Russia and the latter's demands for the payment of moratory interest were denied by Turkey , thus giving rise to the dispute which became the subject of an arbitration agreement. Among the defenses cited by Turkey was *force majeure,* and it was able to prove that from 1881 to 1902, it underwent[203]

> financial difficulties of the utmost seriousness, increased by domestic and foreign events (insurrections and wars) which forced it to make special application of a large part of its revenues, to undergo foreign control as to part of its finances, to grant even a *moratorium* to the Ottoman Bank, and, generally, it was placed in a position where it could meet its engagements only with delay and postponements, and even then at great sacrifice.

According to the tribunal,[204]

> force majeure may be pleaded in opposition in public as well as in private international law. International law must adapt itself to political necessities. (emphasis added).

The same point was readily admitted by Russia, stating that the obligation to carry out treaties may give way "if the very existence of the state should be in danger, if the observance of the international duty is...'self-destructive'."[205]

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of a state of necessity is entirely voluntary and intentional conduct." 2 Y.B. INT'L. L. COMM'N. 50, U.N. Doc. A/CN.4/SER.A/1980/Add.1 (Part 2).

200 The point whether it was fair or not to allow a state an excuse on the ground of state of necessity under the stated circumstance was brought up by Mr. Ago in 1 Y.B. INT'L. L. COMM'N. 181 at paragraph 26, U.N. Doc. A/CN.4/SER.A/1980.

201 *Decision of Hague Court of Arbitration in Russia v. Turkey,* November 11, 1912, in 7 AM. J .INT'L. L. 178-201 (1913).

202 Article 5 of the Treaty of Peace quoted *id.* at 183.

203 *Id.* at 195.

204 *Id.*

205 *Id.*

However, it was established that during the same period that it failed to pay Russia and particularly after the creation of the Ottoman Bank, Turkey "was able to obtain loans at favorable rates, redeem other loans, and, finally, pay off a large part of its public debt, estimated at 350,000,000 francs."[206] The tribunal declared:[207]

> It would clearly be exaggeration to admit that the payment (or the obtaining of a loan for the payment) of the comparatively small sum of about six million francs due the Russian claimants would imperil the existence of the Ottoman Empire or seriously compromise its internal or external situation. The exception of *force majeure* cannot, therefore, be admitted.

The ILC pointed out that the Court above "thus recognized the existence in international law of an 'excuse of necessity', but only within very strict limits."[208] The ILC properly distinguished the above case from one involving *force majeure* which requires an absolute impossibility.

The issue of the availability of a "state of necessity" as a circumstance precluding wrongfulness was also invoked in the case of *The "Societe Commerciale de Belgique,"*[209] although the ground was referred to, again, as "*force majeure.*" According to the Greek Government, there was no refusal on its part to carry out two arbitral awards requiring it to pay a certain sum to the private Belgian company; however, payment of the sum was made impossible by reason of its financial and monetary position.[210] Hence, it pleaded that the Belgian company's claim taken up by the Belgian government be dismissed and the Court declare that Greece was prevented by *force majeure* from carrying out its obligations under the arbitral awards.[211] The Court, however, did not decide on the issue and ruled instead that the question of Greece's capacity to pay was outside the scope of the proceedings before it, noting that[212]

> Nor could submission No. 4 of the Greek Government be entertained if it were regarded as a plea in defence designed to obtain from the Court a declaration in law to the effect that the Greek Government is justified, owing to *force majeure*, in not executing the awards as formulated. For it is clear that the Court could only make such a declaration after having itself verified that the alleged financial situation really exists and after having ascertained the effect which the execution of the awards in full would have on that situation...

As the ILC observed, the last sentence in the decision of the Court quoted above shows that "it implicitly accepted the basic principle on

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206 *Id*. at 196.
207 *Id.*
208 2 Y.B. INT'L. L. COMM'N. 36, U.N. Doc. A/CN.4/SER.A/1980/Add.1 (Part 2).
209 *The "Societe Commerciale de Belgique"*, 1939 P.C.I.J. (ser. A/B) No.78 157.
210 *Id.* at 171.
211 *Id.* at 163 and 164.
212 *Id.* at 178.

which the two parties were in agreement"[213] regarding the circumstance of state of necessity.

4.2. *Supervening Impossibility of Performance and* rebus sic stantibus

4.2.1. *Supervening impossibility of performance*

In the two Vienna Conventions on the Law of Treaties, the concept of *force majeure* is reflected in Article 61(1) on the supervening impossibility of performance in accordance with treaty obligations which states:

> A party may invoke the impossibility of performing a treaty as a ground for terminating or withdrawing from it if the impossibility results from the permanent disappearance or destruction of an object indispensable for the execution of the treaty. If the impossibility is temporary, it may be invoked only as a ground for suspending the operation of the treaty.

The above provision, therefore, is of limited application as it is restricted to instances only where the absolute or objective impossibility arises from the permanent disappearance of an object which, in turn, must be indispensable for the treaty's execution. The disappearance of the money proceeds of the loan agreement without any party's fault is rather difficult to contemplate. But where the repayment of a loan is tied to a specific project, with a percentage of the project's production output (usually in the form of raw or semi-processed materials) or the proceeds thereof committed as the source of repayment of the interest and principal, the destruction of the project due to causes which cannot be ascribed to the debtor state may be invoked as a ground for the termination of the treaty. If the operation of the project is temporarily halted because of continuing hostile combat operations in the area where the project is located, then the treaty may be suspended. Of course, in the absence of a tie-up between repayment and the operation of the project, the destruction of the project will not affect the loan obligation under the treaty. The intent of the parties as reflected in the terms of the agreement, particularly the purpose clause, if any, will have considerable weight in the determination of whether or not the project was intended to be self-liquidating and repayment of the loan subject to the continuing viability of its operations.

Impossibility of performance, however, cannot be invoked if the impossibility is the result of a breach, by the party invoking it, either of an obligation under the treaty or of any other international obligation owed to

213 2 Y.B. INT'L. L. COMM'N. 38, U.N. Doc. A/CN.4/SER.A/1980/Add.1 (Part 2). In their presentations on the issue of whether or not a state is obliged to pay its debt if in order to pay it the state would have to jeopardize its essential public services, the Belgian and Greek governments were in agreement that the state is not obliged to do so. The case is extensively discussed in 2 Y.B. INT'L. L. COMM'N. 61, U.N. Doc. A/CN.4/SER.A/1978/Add.1 (Part 1), at pages 129 to 141 particularly paragraph 288.

any other party to the treaty.[214] Thus, in the first example cited in the previous paragraph, if the destruction of the project was attributable to the borrowing state, then this would not constitute a valid ground for terminating or suspending the treaty under Article 61(1). The International Law Commission recognized that temporary impossibility of performance "might be regarded simply as cases where *force majeure* could be pleaded as a defence exonerating a party from liability for non-performance of the treaty."[215] Nevertheless it decided that, "when there is a continuing impossibility of performing recurring obligations of a treaty, it is desirable to recognize, *as part of the law of treaties*, that the operation of a treaty may be suspended temporarily."[216]

4.2.2. Rebus sic stantibus

A related concept to the supervening impossibility of performance is that of fundamental change of circumstances. There is indeed some overlap of the two since, as the ILC has pointed out, cases of supervening impossibility of performance "are *ex hypothesi* cases where there has been a fundamental change in the circumstances existing at the time when the treaty was entered into."[217] The ILC decided, however, that while there might be borderline cases, the criteria to be employed in applying the two rules are not the same, and to combine them "might lead to misunderstanding."[218]

Article 62 of the Vienna Convention states thus:

> 1. A fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless:
>
> (a) the existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and
>
> (b) the effect of the change is radically to transform the extent of obligations still to be performed under the treaty.

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214 Article 61(2) of Vienna Conventions I and II.

215 2 Y.B. INT'L. L. COMM'N. 256, U.N. Doc. A/CN.4/SER.A/1966/Add.1 (Part 2).

216 *Id.* The ILC, in its commentary on draft Article 31 on state responsibility took note of the proceedings in the drafting of the Vienna Convention on the Law of Treaties I provision on supervening impossibility of performance. While *force majeure* is not specifically mentioned in that Convention,"...It seems none the less certain that the discussions which took place on this point revealed a general belief that impossibility, or at the very least material impossibility, of complying with a treaty obligation constituted a circumstance precluding the wrongfulness of the conduct adopted by the State having the obligation." 2 Y.B. INT'L. L. COMM'N. 125, U.N. Doc. A/CN.4/SER.A/1979/Add.1 (Part 2).

217 2 Y.B. INT'L. L. COMM'N. 256, U.N. Doc. A/CN.4/SER.A/1966/Add.1 (Part 2).

218 *Id.*

The limiting conditions contained in this definition are:[219] (1) the change must be of circumstances existing at the time of the conclusion of the treaty; (2) that change must be a fundamental one; (3) it must also be one not foreseen by the parties; (4) the existence of those circumstances must have constituted an essential basis of the consent of the parties to be bound by the treaty; and (5) the effect of the change must be radically to transform the scope of obligations still to be performed under the treaty.

The Restatement of the Law, Second of the United States, on the other hand, adopts the "reasonable expectations" approach, which is a variation of the subjective theory of *rebus sic stantibus*, by stating the doctrine as follows:[220]

> An international agreement is subject to the implied condition that a substantial change of a temporary or permanent nature, in a state of facts existing at the time when the agreement became effective, suspends or terminates, as the case may be, the obligations of the parties under the agreement to the extent that the continuation of the state of fact was of such importance to the achievement of the objectives of the agreement *that the parties would not have intended* the obligations to be applicable under the changed circumstances.

Under this formulation, the subsequent state of bankruptcy of the debtor-state will not fall within the scope of this article since it was not in the contemplation of the contracting parties that the debtor would cease to perform his obligations once it became insolvent.[221]

It is to be noted that the representatives to the ILC were agreed that mere changes of policy on the part of a government cannot normally be invoked as bringing the principle of fundamental change of circumstances into operation.[222] Thus, if there is a shift in the policy of a government toward the rejection of loan agreements contracted with other international persons, such changes would not fall within the contemplation of the article. A proposal in the Convention for the inclusion of a provision that would have totally excluded a subjective change in the attitude or policy of a government, however, was not approved since some representatives felt that "it would be going too far to state that a change of policy could never in any circumstances be invoked as a ground for terminating a treaty."[223] A treaty of alliance was cited as a case where a radical change of political

219 *Id.* at 259, paragraph 9.

220 AMERICAN LAW INSTITUTE, RESTATEMENT (SECOND) OF FOREIGN RELATIONS Section 153 (1965), emphasis supplied. The 1986 tentative draft of the Restatement of Foreign Relations (Revised) Section 336 contains a provision redrafting the old Section 153 to conform with the provisions of the Vienna Conventions on the Law of Treaties which adopt the objective theory.

221 G. Frankenberg and R. Knieper, *Legal Problems of the Overindebtedness of Developing Countries: The Current Relevance of the Doctrine of Odious Debts*, 12 INT'L. J. SOCIOLOGY L. 422 (1984).

222 2 Y.B. INT'L. L. COMM'N. 259, U.N. Doc. A/CN.4/SER.A/1966/Add.1 (Part 2).

223 *Id.*

alignment by a state's government "might make it unacceptable, *from the point of view of both parties* to continue with the treaty."[224]

Under the Vienna Conventions, a fundamental change of circumstances can be invoked not only as a ground for terminating or withdrawing from a treaty but also for suspending its operation.[225] This is to be differentiated from the treatment of impossibility of performance where only a permanent impossibility is a ground for termination or withdrawal while a temporary impossibility can only be invoked as a ground for suspending the operation of a treaty.[226]

In cases involving a suspension of the operation of a treaty covering a loan agreement, the parties are released from the obligation to perform in accordance with the treaty's terms during the period of suspension.[227] The suspension does not otherwise affect the legal relations between the parties established by the treaty,[228] and the parties are under an obligation to refrain from acts tending to obstruct the resumption of the operation of the treaty.[229] The obligation to repay ultimately whatever amounts the debtor-state has received, therefore, subsists although the duty to repay has been, in the meantime, suspended.

The termination of the treaty, on the other hand, releases the parties from any obligation further to perform the treaty,[230] but termination does not affect any right, obligation or legal situation of the parties created through the execution of the treaty prior to its termination[231] --thus giving termination *ex nunc* effects. From the standpoint of the debtor-state, therefore, it may be at times more advantageous to have the treaty suspended rather than terminated because during the period of suspension, it is temporarily released from its obligation to repay, while such a reprieve may not be available with respect to amounts received under a treaty which was subsequently terminated and which amounts have become due and demandable.

4.2.3 *Government succession*

With respect to previous applications of the principle of *rebus sic stantibus* involving subjective changes in policy which took place as a consequence of a change in government, the Vienna Conventions appear not to have closed the doors entirely on them. Much less do the Conventions affect municipal law decisions on the matter. There is, for instance, a

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224 *Id.*

225 Article 62(3) of Vienna Convention I and 62(4) of Vienna Convention II.

226 Article 61(1) of both Conventions.

227 Article 72(1)(a) of both Conventions.

228 Article 72(1)(b) of both Conventions.

229 Article 72(2) of both Conventions.

230 Article 70(1)(a) of both Conventions.

231 Article 70(1)(b) of both Conventions.

decision of the Swiss Federal Court on the issue of the binding effect of the Hague Convention on Civil Procedure on the Union of Soviet Socialist Republics after the overthrow of the Russian Czarist regime which had signed the treaty.[232] While reaffirming the rule that government succession does not change the international rights and obligations of a state, the court also specifically recognized, by way of an *obiter dictum* that[233]

> The fact that, in the particular case, the change in the form of government of Russia has carried a profound alteration of all the internal juridical organizations and of the relations of individuals among themselves and with the State, the fact that from all this there has resulted a situation contrasting fundamentally with the order prevailing in all the other European States, may have given to the other contracting States the right to withdraw eventually from the agreement, by virtue of the principle of public law known under the name of *clausula rebus sic stantibus*, by reason of the disappearance of the state of things in view of whose existence and continuation the Convention was concluded.

Marek, in her work on state succession, is of the view that the repudiation by the Soviet Union of the debts of the Czarist regime was made under the *clausula rebus sic stantibus*. She cites as evidence the following portion of the memorandum of 20 April 1922 presented by the Soviet delegation at the Genoa Conference:[234]

> Si le Pouvoir des Soviets s'est refuse a reconnaitre les engagements des gouvernements precedents ou a satisfaire les pretentions des personnes qui ont souffert de ses mesures de politique interieure...ce n'est pas qu'il soit "incapable" ou "indesireux" de faire honneur a *ses* engagements, mais pour bien des raisons de principe ou pour des motifs de necessite politique.--La revolution de 1917, par le fait meme qu'elle detruisait de fond en comble l'ancien etat de chose politique,social et economique, pour mettre a sa place une organisation toute differente nouvelles, *interrompait la continuite des engagements civils faisant partie integrante du regime economique de la societe disparue, et ces engagements tomberent en decheance en meme temps que cette societe meme...Cette revolution fut un cataclysme grandiose tel que le monde n'en a connu qu'a des moments exceptionnels de son histoire et son caractere de* force majeure ne peut etre discute par aucun homme d'Etat objectif.

Korovin also expounded on the train of argument adopted by the Soviets as follows:[235]

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[232] The case of *Lepeschkin v. Gosweiler et Cie* decided in 1923. Cited in the Harvard Research on the draft convention on the law of treaties, in the supplement to 29 AM. J. INT'L. L. 1103-1104 (1935).

[233] *Id.*

[234] K. MAREK, IDENTITY AND CONTINUITY OF STATES IN PUBLIC INTERNATIONAL LAW (1968).

[235] Korovin, *Soviet Treaties and International Law*, 22 AM. J. INT'L. L. 178 (1928).

> Every international agreement is the expression of an established social order, with a certain balance of collective interests. So long as this social order endures, such treaties as remain in force, following the principle, *pacta sunt servanda,* must be scrupulously observed. But if in the storm of a social cataclysm one class replaces the other at the helm of the state, for the purpose of reorganizing not only economic ties but the governing principles of internal and external politics, the old agreements, insofar as they reflect the preexisting order of things, destroyed by the revolution, become null and void. To demand of a people at last freed of the yoke of centuries the payment of debts contracted by their oppressors for the purpose of holding them in slavery would be contrary to those elementary principles of equity which are due all nations in their relations with each other.

He also stated, however, that while the Soviet view thus set forth appears to be an extension of the principle of *rebus sic stantibus,* this view also limits the principle's application to a single circumstance--the social revolution.

The arguments forwarded in 1959 by Iraq for the annulment of treaties relative to military and economic aid contracted by the previous government with the United States also invoked *rebus sic stantibus.* As narrated by Vamvoukos,[236]

> The Iraqi Government stated that the revolution of 14 July 1958 had caused a 'vital change' in Iraq's internal structure, the result of which was the establishment of a Republican regime pursuing a policy of 'positive neutrality'. The abrogated agreements imposed on Iraq a political course inconsistent with that policy. The Republic Government therefore came to the conclusion that 'the said military agreements are no longer in line with Iraq's true position after the 14th July revolution, because of the change of conditions...'and expressed the hope that the United States would 'appreciate the change of conditions in Iraq and the need to change and develop Iraq's international relations in accordance with the new political line.'

While it is generally agreed that government succession does not affect the continuity of a state's existence and its international rights and obligations, the views of Marek and others regarding the possibility of a successor government not being bound by the debts contracted by its predecessor have been criticized as "improper"[237] and "untenable."[238] As another writer asserts, "that the rule has not been complied with on occasion, does not put its existence into question."[239] The frequently-

[236] VAMVOUKOUS, TERMINATION OF TREATIES IN INTERNATIONAL LAW 110 (1985).

[237] J. Foorman and M. Jehle, *Effects of State and Government Succesion on Commercial Bank Loans to Foreign Sovereign Borrowers,* U. ILL. L. REV. 9, 21 (1982).

[238] WOOD, *supra* note 8, at 4-50 and 4-50.1.

[239] DELAUME, LEGAL ASPECTS OF INTERNATIONAL LENDING AND ECONOMIC DEVELOPMENT FINANCING 315-316 (1967). Philip Wood summarises the rule as

invoked cases illustrating the general rule are *Republic of Peru v. Dreyfus Bros. and Co.* and *Republic of Peru v. Peruvian Guano Co.*,[240] and the *Arbitration Case Between Great Britain and Costa Rica* decided by William H. Taft.[241]

While the last mentioned case does illustrate the rule that government succession does not affect state responsibility for debts, it is seldom acknowledged that in the same case the arbitrator also found that the lender bank "had not demonstrated that it had acted in good faith or that it had furnished the money for a legitimate government."[242]

In that case, Frederico Tinoco overthrew the government of President Alfredo Gonzales in 1917 and ruled the country until 1919 when Tinoco "retired", and left the countr;. Among the first acts of the restored government was to pass a Law of Nullities invalidating all contracts between Tinoco and private persons, as well as decrees authorizing the issuance of currency notes. While the arbitrator ruled that the restored government was liable for the acts of the Tinoco regime, it found the Costa Rican government not liable for the $100,000 paid by the Royal Bank of Canada to Tinoco "for expenses of representation of the Chief of State in his approaching trip abroad" and for another $100,000 to Tinoco's brother for four years salary and expenses of the Costa Rican Legation in Italy. According to the arbitrator, the whole bank transaction was full of irregularities:[243]

> There was no authority of law...for making the Royal Bank the depositary of a revolving credit fund...The thousand dollar colones bills were most informal and did not comply with the requirements of law as to their form, their signature or their registration.

More importantly, Taft made the following finding:[244]

> The case of the Royal Bank depends not on the mere form of the transaction but upon the good faith of the bank in the payment of money for the real use of the Costa Rica Government under the Tinoco regime. It must make out its case of actual furnishing of money to the government for its legitimate use. It has not done so. The bank knew that this money was to be used by the retiring president, F. Tinoco, for his personal support after he had taken

follows: "A change in government does not release the state of debts incurred by a former government even if the contracting government was unconstitutional or did not achieve international recognition." WOOD, *supra* note 8, at 4-112 and 4-113.

240 These are more popularly known as the Peruvian Guano cases reported in 38 L.R. 348 (1888) and 36 L.R. 489 (1887), respectively.

241 18 AM. J. INT'L. L.147 (1924).

242 This fact is, however, noted by J. Foorman and M. Jehle, *Effects of State and Government Succession on Commercial Bank Loans to Foreign Sovereign Borrowers*, U. ILL. L. REV. 19 (1982).

243 18 AM. J. INT'L. L.147, 168 (1924).

244 *Id.*

> refuge in a foreign country. It could not hold his own government for the money paid to him for this purpose.

Thus, the case "employs an equitable notion that a lender's knowledge, whether actual or imputed, of an illegitimate use of proceeds should nullify its claim."[245]

4.3. Changes in the loan agreement effected by the debtor-state

If the applicable law in a loan agreement is not the law of the debtor-state, changes effected by the debtor including moratoria, reduction of the interest rate, or the imposition of taxes on payments made to the lender, usually will not be recognized.[246]

However, a debtor-state has a considerably greater degree of control over a loan agreement which stipulates the law of the debtor-state as the applicable law of the agreement. Where an action is brought before the local courts, and particularly in the absence of "stabilization clauses" which freeze the applicable law to the state of the law at the time that the agreement was forged, the debt is not insulated from changes in legislation or in their interpretation effected by organs of the debtor-state. Thus, provided the measures are not discriminatory, a debtor-state can blunt the debt's impact by, among others, regulating the interest rate or the foreign exchange rate, or "inflating" the debt away.[247] But, of course, agreements specifying the law of the debtor-state as the applicable law are rare or involve relatively meager amounts; besides, loans of this type often offer the best terms, and one does not offend friends just to drive home a legal point.

However, if an action is brought before a foreign court, and the circumstances surrounding the loan are as those described above, the

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[245] J. Foorman and M. Jehle, *supra* note 241, at 19.

[246] WOOD, *supra* note 8, at 4-61. Sovereign immunity, on the other hand, is not available as a defense in cases involving sovereign debt before most western jurisdictions. Besides specific stipulations in the loan agreement indicating that such loans are commercial in nature, national legislation, as exemplified by the United Kingdom's State Immunity Act 1978, also have applicable provisions. Section 3(3) of the Act states that "commercial transaction", means, among others, "any loan or other transaction for the provision of finance and any guarantee or indemnity in respect of any such transaction or of any other financial obligation." [reprinted in 17 I.L.M. 1123 (1978)]. In the U.S. Foreign Sovereign Immunities Act of 1976, 90 STAT. 2891, 28 U.S.C.A. Sections 1330, 1332, 1391, 1441, 1602-1611 (1976), a foreign state has no immunity from court jurisdiction in cases "in which the foreign state has waived its immunity either explicitly or by implication..." or "in which the action is based upon a commercial activity carried on in the United States by the foreign state; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside of the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States." (Section 1605).

[247] WHITE, *supra* note 12, at 152; WOOD, *id.* at 4-56.

treatment of changes effected by the debtor-state can vary. There are commercial jurisdictions which have upheld such debtor-state action,[248] although where the public policy of the forum is violated, such action may not be given effect.[249] On the other hand, some countries like France are "apparently less willing to recognise unilateral modifications to contractual obligations in the case of contracts involving 'international payments.'"[250]

The right of a creditor is, without doubt, property; hence it is not immune from regulation by the state. If such property right is expropriated by the debtor-state,

> As a very broad generalisation and subject to various exceptions, the cases in industrialised states seem to indicate that external courts will recognise an expropriatory decree affecting an asset located within the legislative jurisdiction of the expropriating state provided that the decree is not, in the eyes of the forum state, so grossly violative of the principles of fair dealing as to disqualify it for recognition on grounds of public policy or flagrant breach of international law...The three key questions therefore are the location of the asset, the concept of public policy and the rules of international law.[251]

Public policy considerations are invoked by every state, thus generally any action taken pursuant to them will be respected by other states.[252] States, however, differ as to their interpretation and application of international law rules applicable to expropriations, particularly on the issue of compensation.[253] The uncertain legal topography, however, may be definitively altered by bilateral investment treaties, many of which are applicable to a broad coverage of investments including the right to receive payments on loans or creditor claims simpliciter.[254] These treaties usually define, among others, the conditions under which expropriation or nationalisation is to be carried out, and set compensation criteria which have to be met by the expropriating state.[255]

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248 WOOD, *id.* at 4-62.

249 *Id.*

250 *Id.*

251 *Id.* at 4-57.

252 *Id.*

253 A discussion of the points on which developing and developed states diverge is beyond the scope of this paper. At least one student paper, however, has suggested that the absence of a "generally accepted rule of international law governing the rights of aliens whose property has been expropriated...presents opportunities to borrowers that may be considering debt repudiation and concomitant dangers to lenders." *The International Law of Compensation for Expropriation and International Debt: A Dangerous Uncertainty*, 8 HASTINGS INT'L. & COMP. L. REV. 223, 223-224 (1985).

254 U.N. CENTRE ON TRANSNATIONAL CORPS., BILATERAL INVESTMENT TREATIES at 16-17, U.N. Doc. ST/CTC/65, U.N. Sales No. E.88.II.A.1 (1988).

255 *Id.* at 55-57.

These leave us, therefore, with the third question on the location of the asset. Generally, expropriation measures are given effect only if the assets sought to be expropriated are located within the jurisdiction of the expropriating state.[256] In some jurisdictions, the act of state doctrine has been applied to bar further judicial inquiry into expropriations carried out by another state with respect to assets located within its territory. Creditor claims simpliciter, however, are intangible movables, and there is no uniformity in the rules observed by different municipal jurisdictions in ascribing location to them.[257] Thus, the situs could be the domicile of the debtor, the place where the debt is recoverable, the country whose law is applicable to the asset, the place where the debt is payable, or on some other criteria.[258] In cases involving the act of state doctrine and affecting debts of foreigners to U.S. creditors, some U.S. courts have adhered to the situs test of whether or not the purported taking can be said to have "come to complete fruition within the dominion of the [foreign] government."[259] A later decision, however, indicated that in such cases, the proper situs test "is where the incidents of the debt, as a whole, place it."[260] Even if the situs test (whichever is applied) is met, one has to contend with the commercial activity exception to the act of state doctrine carved out by a plurality of the U.S. Federal Supreme Court. Under this exception, the act of state doctrine is inapplicable to a "repudiation of a purely commercial obligation owed by a foreign sovereign or by one of its commercial instrumentalities."[261] Most loan agreements involving private commercial banks and debtor-states stipulate that the loan extended is a commercial one.

An entirely independent issue is, if in all cases, the competence of the borrower is judged or determined by its internal law, whether the state can change the rules governing its own competence or that of its representatives and apply such changes retroactively to loan agreements

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256 WOOD, *supra* note 8, at 4-57.

257 In Tabacalera Severiano Jorge, S.A. v. Standards Cigar Co., 392 F. 2d 706, 714-715 (5th Cir.), *cert. denied* ; 393 U.S. 924; 89 S.Ct. 255; 21 L.Ed.2d 260 (1968), a U.S. court noted that the rules for determining the situs of intangible property can differ depending on the purpose involved, i.e., taxation, venue, or the application of the act of state doctrine.

258 WOOD, *supra* note 8, at 4-58.

259 Allied Bank International v. Banco Credito Agricola de Cartago, 757 F.2d 516, 521 (1985); Tabacalera, 392 F.2d at 715-716.

260 Callejo v. Bancomer, S.A., 764 F.2d 1101, 1123 (1985). According to the court, "One relevant factor is the place where the deposit is carried...In addition,...the place of payment, the intent of the parties (if any) regarding the applicable law, and the involvement of the American banking system in the transactions." The U.S. courts have avoided applying the test, applied in cases involving U.S. debtors of foreign creditors, that "a debt is not 'located' within a foreign state unless that state has the power to enforce or collect it...because the foreign state in almost all instances can in theory enforce a debt since the foreign national will in most instances be domiciled in a foreign nation..." *See* Libra Bank Ltd. v. Banco Nacional de Costa Rica, 570 F.Supp. 870 (1983).

261 Alfred Dunhill of London, Inc. v. The Republic of Cuba, 425 U.S. 682, 695; 48 L.Ed.2d 301; 312, 96 S.Ct. 1854, 1861 (1985).

contracted in the past. If the general rule applied in municipal private law is that, unless there is a stabilization clause, a contract is subject not only to the law as it is found at the time that the agreement was entered into, but also to changes in that law, then there is ground for arguing that such changes should be given application. But this would constitute a violation of a principle in private law contracts that a party cannot unilaterally avoid its obligations under a contract, and hence, is not certain to be upheld except perhaps by tribunals of the debtor-state.

4.4. Development and debt

As adverted to in a number of instances above, the strict requirements that have to be met in the application of certain international law concepts, applied as isolated rules, to the problem of Third World foreign debts may render them of marginal value in addressing the debt burden. For instance, we have seen the rigid requirements imposed by international tribunals for the application of state of necessity and *force majeure;* the concept of odious debts is applied only to cases of succession of states, but not to government succession.[262] It has been suggested, however, that such rules should be placed in the context of an emerging law of development which has its foundations in the U.N. Charter.[263] It has been asserted that[264]

> ...The co-operative, and above all the developmental, law of the nations transform the idea of sovereign equality of all states and impose positive duties to be acted upon by the states. The idea of legal equality of all states is linked to the normative postulates of a new international legal and economic order: international solidarity and international social justice... They are based on an empirically informed notion of political and socio-economic inequality in the North-South relationship. The core of this new normative program is outlined in Arts. 1-3 of the U.N. Charter and operationalized in Art. 55.

Accordingly, since states are the ones bound by the general consensus of development, they are obligated to orient their grant of public credits and their guarantee of private credits "around the projected aims the states have jointly subscribed to."[265] Additionally, states are obligated to make

262 G. Frankenberg and R. Knieper, *supra* note 74, at 415, 431.

263 *Id.*

264 *Id.*

265 *Id.* at 433. According to the writers, an "obligation of all states...can be drawn from the projected aims of the U.N. and its organisations, to make every effort within their powers which are apt to (1) narrow the 'gap in wealth' between the industrially-developed and the under-developed societies (Art. 14); (2) secure the provision of foodstuffs and (3) develop and expand production structures which will put especially the LLDCs in a position to participate in international trade (Art. 58)." This obligation is violated "if states require or grant to public credits or secure private credits with public guarantees for investments that are demonstrably unproductive and inimical to development."

the availment and safeguarding of credits "transparent and measured against the projected normative goals of the 'community of nations.'"[266]

While private law creditors are not under an obligation to promote development, it is contended that "they must reckon with a successor government raising the objection that this or that commitment entered into by their predecessor was an odious debt whose fulfillment will be refused."[267] The private creditors then would have to establish that their credit was employed for the debtor-state's national developmental interest,[268] a burden-of-proof approach which is not far from that fashioned by the arbitrator in the *Tinoco* case.[269] The burden of proof should also be on the creditor in cases involving project loans which are released in stages and only after inspection by the creditor to determine if the construction is in compliance with the loan agreement. Knowledge on the creditor's part of any irregularity in the use of the proceeds of the loan can be reasonably imputed in such cases.

The requirements of development can also serve as a standard for determining the application of circumstances precluding wrongfulness, particularly state of necessity, on the part of a debtor-state which is unable to meet its financial obligations under a loan agreement.[270]

It has been further suggested that tribunals judging loan agreements with developing countries on the basis of private law must consider contractual validity limitations found in all systems of national law, particularly the following:[271]

> (a) any gross disproportion of quid pro quo, especially if it has come about as a result of exploiting the inexperience of one of the contracting parties;
>
> (b) the basis of transaction; and

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266 *Id.*

267 *Id.*

268 *Id.* at 434.

269 See *supra* text accompanying notes 241 to 244.

270 The South African Government, in response to a solicitation for comments by the Preparatory Committee of the Conference for the Codification of International Law (The Hague, 1930), pointed out that: "If, through adverse circumstances beyond its control, a State is actually placed in such a position that it cannot meet all its liabilities and obligations, it is virtually in a position of distress. It will then have to rank its obligations and make provision for those which are of a more vital interest first. A State cannot, for example, be expected to close its schools and universities and its courts, to disband its police force and to neglect its public services to such an extent as to expose its community to chaos and anarchy merely to provide the money wherewith to meet its moneylenders, foreign or national. U.N. Doc. A/CN.4/315 reprinted in 2 Y.B. INT'L. L. COMM'N. 61 at 84. U.N. Doc. A/CN.4/SER.A/1978/Add.1 (Part 1). It is submitted that, in determining the priorities, the developmental needs of the state will have to be taken into account.

271 *Id.* at 421.

(c) the violation of obligations to inform the other contracting party, and other limitations and modification of freedom of contract, which are dealt with under the general norms of private law and constantly being brought up to date.

5. CONCLUSION

The binding force of the promissory rule of conduct among subjects of international law lies in the principle *pacta sunt servanda*. While the security of inter-state obligations is of primordial consideration, however, international law also provides for mechanisms that allow for the readjustment of international obligations. Some of these mechanisms have been discussed in the preceding survey of the possible grounds for disengagement relating to the contracting and the performance of loan agreements. In some cases, however, the requirements that have been imposed by international tribunals for availing of such mechanisms, are quite stringent,[272] but with the growth of recognition for the right of Third World countries to development, the minimum standards for development can be employed to mitigate the harshness of previous applications of these requirements. Thus, for instance, the admissibility of a plea based on state of necessity as a circumstance precluding wrongfulness can be judged against the developmental needs of the invoking state.[273]

We have also seen, however, that many current loan transactions are not inter-state transactions, nor are they always taking place between international law persons. Instead, they have been contracted between sovereign debtors and private law creditors under the municipal law of some state. While it has also been noted that there remain questions regarding the binding character of such obligations on the sovereign debtor, it is however clear that such loan agreements have opened debtor-states to suits from private law creditors before jurisdictions which recognize the binding character of those agreements. In these cases, the tribunal concerned, in the face of the sovereign personality of one of the parties, may find ordinary private law rules inadequate and resort to international rules for guidance or application. The tribunal, therefore, will have much leeway in the determination of which rules to apply, because of the inadequacy or absence of specific municipal law rules, but whether the tribunal resorts to international law or applies municipal law, it will not be lacking in principles or rules that can be applied in order to avoid unjust situations. Indeed, municipal law rules may be less prone to ignore "actual inequalities of power", and more willing to apply equitable principles in private contract law.[274]

It is also possible, however, that a tribunal applying the applicable law of a loan agreement which is the municipal law of some

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272 See Parts 3 and 4, *supra*.

273 See *supra* text accompanying note 267.

274 G. Frankenberg and R. Knieper, *supra* note 74, at 419.

State may hesitate to do so for fear of rendering contractual relations unstable. On the contrary, effecting a readjustment, where proper, renders such contractual arrangements even more stable as sovereign debtors' confidence in the municipal law systems of other countries will be strengthened. Failure to recognize inequities where they exist and are legally cognizable only reinforces the perception that choice of law and choice of forum clauses in loan agreements are designed to stack the cards in the creditors' favor under all circumstances. Implementing legal recognition of grounds for readjustment, on the other hand, will be in full accord with the duty of states to co-operate toward the full development of all States and, in most cases, a positive act toward the realization of the right of Third World peoples not to be despoiled of their national wealth.

As a prolegomenon, this study has not exhausted the various legal issues associated with selective disengagement of foreign sovereign debts. In order to do that, it is necessary that loan agreements contracted by particular sovereign debtors should be analyzed individually as well as in their totality, and the determination of whether to pursue selective disengagement can only be made on a case-to-case basis depending on the circumstances surrounding the contracting or performance of each loan transaction. The possibilities for selective disengagement are endless. The facts surrounding each loan transaction may give rise to a different legal ground or grounds. What has been sketched in the preceding sections are some of the broad outlines.

The study has also revealed uncertainties surrounding application by tribunals of grounds for selective disengagement. Nevertheless, the overall uncertainty constitutes part of the armour of sovereign debtors. The lenders, whether they are states or private institutions, are, like the sovereign debtors, just as unable to predict the final outcome of a legal battle or unequivocally decide if one should be fought at all. Thus, pressure is exerted on the creditors to arrive at some agreement addressing the overindebtedness of their Third World debtors. Furthermore, as we have seen, there are also cases where there is neither tentativeness nor uncertainty and where the debtor-state undeniably has the upper hand.

Finally, the study is cognizant that debt agreements do not exist in vacuous space. Instead, they are rooted in some legal *terra firma*. The study instructs that it is from the same legal soil on which debt agreements grow that grounds for selective disengagement nourish themselves.