

Recent Development on the Necessity Test in International Investment Law

LI Ke

Faculty of Law, University of Macau

ABSTRACT. *In the international investment law, the “state of necessity” is invoked to preclude the wrongfulness of host states’ measures, no matter whether there is a “non-precluded measure” clause contained in the concerned BIT or not. Decisions on investor-state disputes against Argentina demonstrated a convergence in the application of the “state of necessity” defence in international investment jurisprudence. Three conditions shall be fulfilled to overturn the “state of necessity” defence: (i) taking alternative measure would be consistent with BITs, (ii) alternative measure shall be in fact available when the measures challenged were taken, and (iii) the alternative measure would have yielded equivalent results/relief with the challenged measure. To exam the availability of alternative measures, the proportionality analysis is widely used by the tribunals. Although the common rule that the burden of proof rests upon the party asserting the affirmative is followed, the burden of proof on claimants is proved to be heavier if they want to overturn the “state of necessity” defence of the defendants.*

KEYWORDS: *Investment law, State of necessity, The proportionality analysis, The burden of proof*

1. Introduction

The doctrine of necessity was codified in Article 25 of the International Law Commissions (ILC’s) Articles on State Responsibility. This article listed four conditions for invoking the doctrine of necessary to preclude wrongful acts that breach international obligations. First, the ‘only way’ test stipulated in Article 25 (1) (a) of ILC’s article requires the approach adopted by states to be the only means of protecting its essential interests, with no existing alternatives. The interpretation and application of the “only way” test triggered extensive debates in international law and lead to divergence of international arbitration awards. The stringent interpretation of the “only way” requirement by the WTO Appellate Body was criticized and then was developed towards a more flexible and relaxed direction. Second, the measures taken by the host state must not seriously impair an essential interest of the state to which the obligation exists. This condition seeks to balance the public interests of the host state with another state to which an equal international obligation exists. The third conditions require that ‘the international obligation in question does not exclude the necessary action, the fourth condition is called “non-contribution” requirement, which requires that the state has not contributed to the situation of necessity.

The four conditions of necessary defence have been implemented in international courts and tribunals, as observed in the investment arbitration against Argentina who suffered severe economic crisis in late 1999. Beginning in late 1999, Argentina suffered a severe economic crisis. Facing the economic downturn, the government of Argentina adopted a series of measures in 2002, including publishing emergency legislation to freeze gas tariffs, abandoning some policies that were originally in foreign investors’ favour and forcing foreign investors to renegotiate utility contracts. Foreign investors raised several claims against Argentina, alleging the country had breached its obligations under international treaties. It is interesting to see that in these cases, claims were made against the same measures Argentina had adopted during the financial crisis. The results in these cases, however, were not the same. Applying the principle of necessity to international investment arbitration (IIA) jurisprudence largely depends on the tribunals’ interpretation of the four conditions and the way they assess and weight the evidence presented by both parties.

In these cases, Argentina used necessary defence either by invoking the “non-precluded measure” clause (NPM clause) in BITs or relying on Article 25 of ILC’s article or both. Although the legitimacy of the application of Article 25 of ILC’s article in investor-states disputes was criticized as it applied exclusively to inter-state relations, it was realized that the involvement of private actors in modern international relations had become a widespread phenomenon. The application of Article 25 of ILC’s article in investment disputes has been widely accepted by tribunals and therefore not falls within the scope of discussion in this paper. By deeply analysing recent jurisprudence in investment arbitration against Argentina, this paper focuses on the necessary

test, it looks into the criteria on the availability of alternative means for a state to protect its public policy objectives in emergency circumstances, and discusses the unification of the criteria for the purpose of increasing the predictability for foreign investments.

2. Necessary Test under Bits without Npm Clause: the Urbaser Case

The claimant in this case is Urbaser S.A. and Consorcio de Aguas Bilbao Bizkaia, Bilbao Biskaia Ur Partzuergoa, shareholders of Aguas Del Gran Buenos Aires S.A. (AGBA) who has been granted a concession for water and sewage service to be provided in the Province of Buenos Aires.

During 2001-2002 Argentina encountered economic crises, and therefore taken some emergency measures. Due to these emergency measures, the claimants suffered financial losses and the concession was finally running into deadlock. AGBA and its shareholders made numerous requests for a new valuation of its tariffs and for a complete review of the concession. However, the negotiating process failed and the province finally terminated the concession in July 2006.

The claimants therefore initiated an investment arbitration proceeding against Argentina, and alleged that the country breached Spain–Argentina Bilateral Investment Treaty, more specifically the “arbitrary, unreasonable and/or discriminatory measures” clause, expropriation clause and “fair and equitable treatment” (FET) clause of the treaty. Although the tribunal found that Argentina breached the FET clause, it accepted the “state of necessity” defence of Argentina.

The claimants argued that “state of necessity” under Article 25 of the ILC’s draft has stricter conditions than defences based on the provisions of different BITs. They insisted that “proving that the measures in question were effective is not enough. It must be established that those measures were the only possible ones and that there was no other one to allow the state of necessity to be overcome.” The claimants further argued that “granting subsidies to lower-income users and/or adjustment of tariffs in a way that the Concessionaire’s income was preserved” was an alternative measure that available to Argentina. As a response, Argentina listed facts to support their argument: “there was no other way to safeguard Argentina’s essential interests”, they had to take the emergency measures to safeguard the essential interests of the country.

The tribunal first examined whether the Argentine Government made a contribution to the economic crisis, and therefore be precluded from invoking the state of necessity. By analysing the reasons of economic crisis, the tribunal found that there was no causation link between Argentine’s conduct and the outbreak of the crisis.

Regarding to the “only way” condition of the state of necessity defence, the tribunal provided a more complicated analysis. The tribunal refused the strict interpretation that insisted by the claimants, but applied a balancing test to see whether the emergency measure was a proportionate means to protect the country’s essential interest. The tribunal states that “the argument, however, has to be taken in observing its reasonable proportions”. It found out that “the emergency measures and the state of necessity associated with them were events of nation-wide importance. Therefore, the question whether “other means” were available has to be captured in both perspectives: the wide one, taking into account the needs of Argentina and its population nation-wide, and the narrower one of the situation of investors engaged in performing contracts protected by the international obligations arising out of one of the many BITs.” Although the tribunal did not mention the jurisprudence in WTO law, when apply the “only way” test, the approach that adopted by the tribunal in the *Urbaser* case is closer to the weighing and balancing test for identifying “reasonable available” alternative measure that adopted in WTO disputes.

When examining whether “granting subsidies to lower-income users and/or adjustment of tariffs in a way that the Concessionaire’s income was preserved” alleged by the claimants was an alternative way, the tribunal questioned the possibility *de facto* of this measure by asking numbers of questions “how would it have been possible to provide subsidies when the State’s and the Province’s finances and budgets were in the centre of the crisis, coupled with serious difficulties to pay the public debts? How would it be possible to obtain a legislature’s approval of a budget reserving special credit for users of a privatized water and sewage network, while no money would remain available for other needs of the population, which were to be met by other providers, not protected by a BIT? How can Claimants envisage and request subsidies taken from the state budget when AGBA had submitted, before the emergency broke out, that the crisis was such that the State was not capable to obtain funding from financial institutions even for the already budgeted and approved current expenditures?” When finding out that the alternative way that alleged by the Claimants were impractical, the tribunal rejected this argument without continuing examining other elements of the necessity test.

3. The Use of Proportionality Analysis

The proportionality analysis has been used not only by investment tribunals to determine whether a government measure is necessary to protect essential public interests (and therefore protected by the ‘non-precluded measures’ clause in treaties), but also in expropriation claims and claims based on fair and equitable treatment.

In the earlier awards the international tribunals only examined the effect of certain measures, concluding that indirect expropriation had taken place if the impact of a measure reached a certain intensity. This unbalanced approach only looked at the effect of the state’s measures. It ignored the objectives of the measures. This was later corrected by the ‘policy power’ doctrine, which emphasised a state’s regulatory power to restrict private property rights without compensation, even if such a provision was not explicitly included in an investment treaty. The ‘policy power’ doctrine has been accepted by investment tribunals, however, the boundary of the non-compensable policy measure has not always been clear. The tribunals in *Tecmed v Mexico* and *LG&E* adopted the proportionality analysis, holding that only state measures that caused disproportional restrictions on private property rights were compensable. The proportionality analysis requires a comprehensive examination and weighing of the conflicts of interest. These include, without limitation, the legitimate expectations of foreign investors, the purpose of government policy measures and other factors such as the cause and effect of the restriction or interference and possible alternatives that are less restrictive but equally effective. The factual elements that have varied in different cases have had a substantial influence on the tribunals. For example, in *LG&E v Argentina*, the tribunal denied an expropriation claim because the challenged governmental measures had not ‘permanently neutralised the benefit of property that was owned by the foreign investors’. The foreign investors had not been deprived of the ‘control or day-to-day operation of the investment’. In the *Urbaser* case, by applying the proportionality analysis, the tribunal found out that “Argentina did not adopt any measure entailing interference with AGBA’s management and did not take any measure depriving Claimants of control over their investment. Claimants have never suffered a substantial deprivation of their ownership or control of their investment. The disputed measures were adopted and applied by the Argentine Republic in the legitimate exercise of its regulatory power.” The tribunal in *Tecmed v Mexico*, however, held that the non-renewal of a license constituted an indirect expropriation. Although the claimants had previously violated the terms of the operation license, the tribunal held the breach had been too marginal to justify the non-renewal of the license.

Similarly, the proportionality analysis has been used by the tribunals in cases such as *Saluka v Czech Republic*, and *Middle East Cement Shipping and Handling v Egypt* to deal with fair and equitable treatment claims. Although there is no uniform standard for conducting proportionality analyses in jurisprudence, the concept of proportionality requires adjudicators to compare, weigh and balance the conflicting interests between foreign investors and host states, instead of prejudicially emphasising only one value while ignoring others

4. The Burden of Proof

In investment disputes, the burden of proof is another factor which will have substantial impact on the final decisions of the tribunals. When applying “state of necessity” defence, no tribunal expressly explained how the burden of proof shared between the claimants and respondents. However, from the jurisprudence of investors-states arbitration, a rule can be concluded.

First of all, to invoke the “state of necessity” defence, the respondents shall make a *prima facie* case to prove that the challenged measure is the “only way” to safeguard its essential interests. In the *Urbaser* case, after Argentina demonstrated the “extreme economic, institutional and social disturbances suffered by the country and its population” when it taken the emergency measures, the tribunal held that Argentina fulfilled its burden of proof by making a *prima facie* case to support its necessity defence. The tribunal also accepted an expert’s statement to make the argument more convincing that “Argentina had virtually no choice but to proceed with devaluation, suspension of debt service payments and the pesification of assets and liabilities”. In *Continental Casualty* case the respondent convinced the tribunal that the measures at issue were “in part inevitable, or unavoidable, in part indispensable and in any case material or decisive in order to react positively to the crisis, to prevent the complete break-down of the financial system, the implosion of the economy and the growing threat to the fabric of Argentinean society and generally to assist in overcoming the crisis.” To overturn the respondents arguments, the claimants shall prove that there is reasonable alternative measure available to the respondent at the time when it apply the challenged measure. The jurisprudence shows that it is more difficult for the claimants to prove “alternative measure” than proving the “only way” by the respondents. In *Urbaser* case, the tribunal asked the Claimants to prove not only the “alternative measure” alleged was “reasonable”, “practical”, and “possible implemented at the time of the crisis and the emergency”. In *Continental Casualty*

case, the Claimants were required to prove the “alternative measures” alleged would have yielded equivalent results/relief with the challenged measure. Therefore when the tribunal found that alternative measures that proposed by the Claimants were “ineffective in lessening the burden on Argentina’s finances and in restoring the public’s confidence”, the tribunal held that these measures were not reasonable alternative measures which can prevent Argentina from revoking “state of necessity” defence.

Second, to prove the condition of contribution, the burden of proof is shift to the claimants. The claimants shall prove that the states has contributed to the situation of necessity, therefore there is no ground for them to invoke the “state of necessity” defence. In *LG&E*, the tribunal held that “no serious evidence in the record that Argentina had contribute to the crisis resulting in the state of necessity”. Instead, it found that “the attitude adopted by the Argentine Government has shown a desire to slow down by all the means available the severity of the crisis” In *Urbaser* case, the tribunal shared the views of tribunals in previous cases against Argentina. To make the standard more clearer, the tribunal stated in the decision that “for such a demonstration to be successful, it should be shown that the Government’s acts were such that they either were directed towards a crisis resulting in the emergency situation that the country experienced in early 2002, or at least of such a nature that the Government must have known that such crisis and emergency must have been the outcome of its economic and financial policy.” The tribunal required the Claimants to prove a link of causality between the conduct of Argentine Government and the outbreak of the crisis.

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