Necessity and the Covid-19 pandemic

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Key points
- As the global economic downturn from the coronavirus worsens, many sovereign debtors will have to choose between paying creditors and fighting the virus.
- Official sector creditors have taken steps to grant relief to the poorest nations, but there is little sign that private creditors will coordinate to voluntarily grant relief.
- Customary international law, through the rarely applied doctrine of ‘necessity’, may provide sovereign debtors with some respite. This doctrine allows sovereigns to temporarily delay performance of international obligations when necessary to mitigate a grave and imminent danger to the populace.

1. Introduction
The Covid-19 pandemic has produced an unprecedented and global economic crisis, which will severely impact the poorest nations. There is widespread agreement that a temporary standstill on sovereign debt payments is necessary to allow countries to devote resources to crisis mitigation. The G20 has agreed to a temporary standstill covering bilateral official loans to a subset of the poorest countries.1 However, the G20 standstill is limited in scope. It does not protect middle-income and many low-income countries, and it does not involve the participation of private creditors. Because of these limitations, a number of authors have proposed mechanisms for implementing a more comprehensive debt standstill.2 The basic idea is to allow countries the option to defer debt payments to both official and private creditors during the Covid-19 crisis.

The implementation of a debt standstill is complicated by the fact that creditor participation under the G20 plan is voluntary.3 In some cases, such as sovereign bonds subject to

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1 Communique, G20 Finance Ministers and Central Bank Governors Meeting, 15 April 2020 <https://g20.org/en/media/Documents/G20_FMCBG_Communiqu%C3%A9_EN%20(2).pdf> accessed 20 May 2020.
2 See Christopher Spink, 'Pressure Mounts to Change EM Standstill Terms', International Financing Review, 21 April 2020 <https://www.ifr.com/story/2328675/pressure-mounts-to-change-em-debt-standstill-terms-l5n2c90ww> accessed 20 May 2020; Patrick Bolton and others, 'Born Out of Necessity: A Debt Standstill For Covid-19' (2020) Center for Economic Policy Research (CEPR) Policy Insight # 103; Lee C Buchheit and Sean Hagan, 'From Coronavirus Crisis to Sovereign Debt Crisis', FT Alphaville, 26 March 2020 <https://ftalphaville.ft.com/2020/03/25/1585171627000/From-coronavirus-crisis-to-sovereign-debt-crisis/> accessed 20 May 2020; Anna Gelpern, Sean Hagan and Adnan Mazarei, 'Debt Standstills Can Help Vulnerable Governments Manage Covid-19', Peterson Institute for International Economics Blog, 7 April 2020 <https://www.piie.com/blogs/realtime-economic-issues-watch/debt-standstills-can-help-vulnerable-governments-manage-covid> accessed 20 May 2020; Ngozi Okonjo-Iweala and others, 'Covid-19 and Debt Standstill for Africa', Brookings Institute Blog, 18 April 2020 <https://www.brookings.edu/blog/africa-in-focus/2020/04/18/covid-19-and-debt-standstill-for-africa-the-g-20s-action-is-an-important-first-step-that-must-be-complemented-scaled-up-and-broadened/> accessed 20 May 2020.
3 In the context of Saudi Arabia being the chair of the G20 in 2020, the Saudi Finance Minister wrote in the Financial Times: ‘We as government leaders are aware that this has to be voluntary. We should avoid imposing anything on the private investors, as it may distort markets and limit future demand for emerging market debt from the private sector. But we strongly encourage them

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collective action clauses (CACs), creditors may decide collectively whether to accept a temporary standstill. In others, the decision would be left to each individual creditor. Either way, there is little to stop less public-spirited creditors from insisting on full payment, even filing lawsuits or arbitration claims to enforce their debts.  

This essay explores whether the defence of necessity protects borrower states from such lawsuits. Section 2 describes the defence and argues that it may well protect states in the unique circumstances of the current pandemic. Section 3 evaluates counter-arguments and objections, including the claim that sovereigns can invoke necessity only to excuse non-performance of an ‘international’ obligation (ie one owed to another state). Section 4 concludes.

2. The general case for necessity

Necessity is a rule of customary international law (CIL). As expressed in Article 25 of the International Law Commission’s Draft Articles on Responsibility of States for Internationally Wrongful Acts, a state can invoke necessity to excuse its non-performance of an ‘international obligation’, if non-performance is the only way to address ‘a grave and imminent peril’, as long as non-performance does not seriously impair an essential interest of the ‘State or States towards which the obligation exists’. Even if these conditions are satisfied, the state cannot invoke necessity to excuse the violation of an international obligation that ‘excludes the possibility of invoking necessity’. (Put differently, the doctrine implies that necessity is a default rule.) Nor can a state invoke the defence if it has contributed to the state of necessity. Finally, even if the defence is available, non-performance is excused only while the threat persists. The state must resume performance when the crisis ends, and it may have to pay compensation for any loss caused by its non-compliance.

Every sovereign debt crisis requires hard choices. Someone must bear the cost of adjustment, and if financial creditors are paid, the borrower will likely have to slash spending on infrastructure development, social welfare programmes and the like. In this sense, every crisis potentially implicates the necessity defence, because every crisis threatens, to some degree, the state’s ability to safeguard the welfare of the populace. But tribunals usually, and we think correctly, reject the defence when raised by a state that has failed to pay to do so’ (Mohammed El Jadaan, ‘Private Sector Should Join Poor Countries’ Debt Relief Plan’ Financial Times, London, United Kingdom, 3 May 2020 (emphasis added)).

4 Excuses for why private creditors might not be able to grant relief on comparable terms to the official sector—vague invocations of fiduciary duties, regulatory requirements and concerns about credit ratings—are already being made by the private sector. See Letter From IIF to World Bank, IMF and Paris Club on a Potential Approach to Voluntary Private Sector Participation in the DSSI (1 May 2020) <https://www.iif.com/Portals/0/Files/content/Regulatory/IIF%20Response%20LIC%20Debt%20Relief%20Initiative%20May%202020.pdf> accessed 20 May 2020; Bank Group Raises Questions on Debt Relief for Poorest Countries, Barrons, 4 May 2020 <https://www.barrons.com/news/bank-group-raises-questions-on-debt-relief-for-poorest-countries-01588629906> accessed 20 May 2020.

5 International Law Commission, Draft Articles on Responsibility of States for Internationally Wrongful Acts, with Commentaries, Article 25. Necessity. November 2001, Supplement No 10 (A/56/10), ch IV.E.1.

6 ibid.

7 ILC Articles, art. 27. Consequences of Invoking a Circumstance Precluding Wrongfulness.
debts. The few exceptions are rare enough to prove the rule. Among other reasons, the state’s own conduct will often have contributed to the crisis, and in such cases the defence is unavailable.

Despite this, the circumstances of the Covid-19 pandemic will present a classic case of necessity for many states. The most fundamental objection to recognizing the defence is that ‘true’ states of necessity are hard to verify. Conditions in the borrower state may be extreme, but perhaps not so extreme that the state can only service its debt by causing a humanitarian disaster within its borders. Or perhaps the state, though seemingly blameless, has in fact adopted policies that contributed to the crisis. A tribunal may doubt its ability to accurately distinguish these scenarios. And it may worry that false positives—in the sense of recognizing a state of necessity that does not in fact exist—may encourage states to invoke the defence opportunistically.

This quite reasonable concern likely explains why tribunals generally reject the defence.

But this concern with verifiability has little relevance in the present circumstances. For example, it is implausible to suggest that any particular state contributed to its own misfortune when the dire economic costs of the pandemic are being felt in ‘every’ state. Statements confirming the state of necessity by the G20 and other official actors can likewise validate the extreme and urgent nature of the present crisis. In this sense, official sector actors can play a certifying role, confirming the severity and global effect of the crisis and providing clear guideposts for when the crisis ends. This does not mean, of course, that the defence will be available to every country. However, many low- and middle-income countries face significant payments on foreign currency-denominated debt. If paying this debt would materially compromise the ability to respond to the pandemic—for instance, by compromising the ability to import testing supplies and medicine—then the case for the necessity defence is relatively clear. As Alan Sykes has noted:

Imagine a developing country facing a deadly tropical disease, and suppose that a costly cure has just been discovered. The government may then have an extremely valuable use for funds that it did not have before. Accordingly, to the list of economic exigencies plausibly justifying measures to conserve government funds, we might add certain scenarios in which the government experiences a
new and pressing need for funds to address some unanticipated domestic emergency—a public health crisis, a natural disaster, and the like.¹²

3. Some objections to the use of necessity in this context

Objections to the invocation of necessity during the Covid-19 crisis focus less on whether a state of necessity exists and more on whether the defence is available to a state faced with claims from private creditors. These objections take a number of forms, which we address briefly here.

Municipal, not international, law governs the rights of many voluntary creditors

One objection invokes the governing law clause found in many contracts, which often designates the municipal law of a foreign state or political subdivision (e.g., the law of New York). The designated municipal law, unlike CIL, may not recognize the defence of necessity.¹³ If a creditor’s claim arises under such a contract, may the state nevertheless invoke necessity as a defence? At least if the contract is governed by the law of New York, the answer should be yes.

Courts in the USA generally understand CIL to be part of federal law and to preempt contrary state law. This understanding of the relevance of CIL has been disputed, most famously by Curt Bradley and Jack Goldsmith.¹⁴ An alternative conception understands CIL to be relevant, in the absence of a statute or treaty, only when incorporated into state law. But under either approach, a generic governing law clause of the sort found in most contracts—‘any dispute arising under or in connection with this contract will be governed by the law of New York’—leaves room for the parties to invoke relevant CIL, including the defence of necessity.

The law of New York has long been understood to incorporate CIL when relevant to the dispute.¹⁵ So even under the narrower view, in which CIL is relevant only when incorporated into state law, a governing law clause that chooses New York law likely permits the parties to invoke CIL. The answer is the same under the more typical view, which understands CIL to be part of federal law and to preempt conflicting state law. Here, the question is whether a governing law clause that designates the law of a US state such as New York implicitly ‘excludes’ otherwise-applicable federal law. It does not. Courts routinely interpret generic governing law clauses of this sort to incorporate both the law of the designated state and any relevant federal law.¹⁶ For example, in the context of

¹² Ibid 314.
¹³ There may be overlapping defences available under municipal law, such as impracticability and frustration of purpose, but the overlap is incomplete.
¹⁴ Curtis A Bradley and Jack L Goldsmith, ‘Customary International Law as Federal Common Law: A Critique of the Modern Position’ (1997) 110 Harvard Law Review 815–76.
¹⁵ See, for example, Bergman v De Sieyes (1948) 170 F 2d 360 (2nd Cir).
¹⁶ John F Coyle, ’The Canons of Construction for Choice-of Law Clauses’ (2017) 92 Washington Law Review 631, 661–5.
arbitration, courts interpret a governing law clause designating state law to incorporate federal arbitration law, not the arbitration law of the designated state. Similarly, in contracts for the sale of goods, courts interpret the governing law clause to incorporate federal treaty law—the United Nations Convention on Contracts for the International Sale of Goods—rather than the designated state’s version of Article 2 of the Uniform Commercial Code. These interpretive practices strongly imply that a governing law clause that specifies the law of New York allows parties to invoke CIL when relevant to the dispute.

**Necessity is a defence only against ‘international’ claims**

A more serious objection posits that, while a state may raise necessity as a defence to a claim asserted by another state, it may not raise the defence against a private creditor. The classic statement of the defence, from Article 25 of the International Law Commission’s (ILC) Articles on State Responsibility, refers to necessity as a ‘ground for precluding the wrongfulness of an act not in conformity with an international obligation . . .’. The German Constitutional Court has ruled that ‘an economically or financially defined state of emergency cannot be raised against private individuals as long as there is no customary international law rule that recognizes the transferability of the plea of emergency from international law to private law’. The Court reached this outcome notwithstanding the fact that international tribunals have long considered (though mostly rejected) the necessity defence when adjudicating disputes between states and private creditors. To take a recent example, a number of International Center for Settlement of Investment Disputes (ICSID, https://icsid.worldbank.org/en/) tribunals reached conflicting rulings on whether the necessity defence was available to Argentina in the wake of its default in the early 2000s. These disputes, however, took place pursuant to bilateral investment treaties between Argentina and the investor’s home state. In such cases, the investor asserts a claim under the treaty, not a contract claim, and treaty compliance is an international obligation. This distinction was enough for the majority of the German Constitutional Court (over a vehement dissent).

The decision has been criticized—in our view, for good reason. It is of course true that Article 25’s articulation of the necessity defence has inter-state disputes in mind (hence, ‘international obligations’). It is also true that, although tribunals have long acknowledged the defence in the context of disputes between states and private creditors, in each of these cases the tribunal’s jurisdiction was founded on an inter-state agreement of some sort. But this history does not lend much support to the German Constitutional

17 Mastrobuono v Shearson Lehman Hutton Inc. (1995) 514 US 52.
18 Coyle (n 16) 693–5.
19 ILC Articles on State Responsibility, art. 25. Indeed, some of the elements of the defence become hard to apply or irrelevant when a private creditor asserts a contract claim against a state. For example, under art. 25, a state may not invoke necessity if non-compliance with its obligations will ‘seriously impair[s] an essential interest of the State or States towards which the obligation exists, or of the international community as a whole’. In the context of a private creditor’s contract claim, the respondent state owes no obligation to another state, so the first part of the question is non-sensical.
20 German Federal Constitutional Court, Decision of 8 May 2007, 2 BvM 1-5/03; NJW 2007 (translation by the authors).
21 Reinisch and Binder (n 10) 118–20.
Court’s ruling. Throughout most of the relevant period, the doctrine of absolute immunity barred private suits against sovereigns. Judges in national courts did not have opportunities to decide whether a sovereign could invoke necessity in such a suit. Nor did international tribunals that ruled on necessity in the context of disputes with private creditors emphasize that the defence was conditional on the presence of an inter-state agreement. Historical practice therefore offers no direct support for the claim that states ‘may not’ invoke necessity to excuse non-performance of a contractual obligation owed to a private creditor. What is clear is that tribunals have long acknowledged the defence when adjudicating claims by private creditors aggrieved by a state’s non-performance of a contract. In the modern era, private creditors do not need an inter-state agreement to press their claims; they can sue foreign sovereigns in national courts. We see little reason why the defence should be unavailable in this functionally identical category of disputes.

Indeed, denying states the necessity defence in contract disputes with private creditors results in strange priority distinctions among creditors. It effectively subordinates official creditors to most private creditors, because only the former risk having their claims deferred. It also subordinates one group of private creditors to another, equivalent group. This is because private claimants who pursue arbitration under a bilateral investment treaty can see their claims deferred; creditors who file lawsuits need not worry. These consequences would be worth tolerating if the doctrine of necessity clearly required them, but it does not.

4. Implications for the long term?

Is there a risk that recognizing necessity as a defence during the Covid-19 crisis will destabilize debt markets over the long term? The concern here is that, once this genie is out of the bottle, investors and other voluntary creditors may worry that sovereigns will invoke necessity opportunistically. This concern with borrower-side moral hazard may drive up borrowing costs. For three reasons, however, we do not think the risk is serious.

First, in the specific context of Covid-19, there is an argument that a debt standstill is consistent with investors’ reasonable expectations. By this, we mean that a standstill is the outcome that reasonable investors would have agreed to if they had thought about these precise circumstances at the time of the investment. A temporary reprieve from debt payments allows the sovereign to devote resources to crisis mitigation, limiting the overall economic fallout and allowing it to resume payments more swiftly. A debt standstill applicable to all creditors—the effective result of recognizing the defence of necessity—also promotes inter-creditor equity. Without a universal standstill, one creditor’s sacrifice may simply line another, identically-situated creditor’s pocket.22

Secondly, tribunals can recognize necessity in the context of Covid-19 without creating a significant risk of false positives (ie cases in which future tribunals incorrectly declare a
state of necessity to exist). As explained above, the global effect of the pandemic, and the explicit recognition of a state of necessity by official actors like the G20, provides clear evidence that a state of necessity exists with clear guideposts for determining the beginning and end of the crisis period. In the absence of these features, a state that invokes necessity as a defence will have a steep hill to climb. Thus, recognizing the necessity defence during the Covid-19 crisis will not create a material risk of opportunistic default in the future.

Finally, we should emphasize the limited consequences of recognizing the defence of necessity. In a state of necessity, the sovereign may ‘defer’ payment of any principal and interest on obligations that come due during the crisis. However, the sovereign will likely have to make these payments once the crisis ends. It may also have to pay compensation to affected investors, likely in the form of interest on the delayed payments. But any compensation would reflect a below-market interest rate. In this sense, investors would suffer a real loss. They would be subsidizing the crisis response, although this does not make them unique. So is every other person with a claim on the sovereign’s resources, including the citizens and residents for whose welfare the state is responsible. We recognize the law is currently unsettled on these points, as revealed in conflicting rulings by ICSID arbitration panels arising from Argentina’s default. Properly understood, however, we think necessity allows only a limited and temporary reprieve.

For some, this might be viewed as a weakness of the necessity defence. As Matthias Goldmann and Michael Waibel have pointed out, necessity may help a state that is experiencing a temporary liquidity crisis, but the defence will not help a sovereign facing a crisis of solvency. But we are inclined to view the limited relief afforded by the doctrine of necessity—delay with compensation, not forgiveness—as a virtue. The defence cannot fill the gaps created by the lack of a bankruptcy regime for sovereign nations. Even if one thought of that as a worthwhile goal, it is too much to ask of this narrowly targeted legal doctrine. A more realistic goal is to recognize that, for a limited time during a severe crisis, a state may prioritize the welfare of its residents over its obligations to creditors. Understood in this limited manner, a state that can afford to honour its obligations will have little incentive to invoke the doctrine opportunistically.

23 ILC Articles on State Responsibility, art. 27.
24 Waibel (n 10) 643.
25 Goldmann (n 10) 18; Waibel (n 10) 642.