International Commerce

November 2012

EUROZONE COLLAPSE - THE LEGAL CONSEQUENCES

The spectre of Eurozone collapse has ebbed and flowed in recent months. A series of candidate countries for departure from the Eurozone has been touted, whereupon pundits have looked to Berlin for signs of the German government's readiness to shore up those countries' finances with further bailout funds. The International Monetary Fund, whose management is dominated by European powers, has also been called in to assist. Nevertheless, as the Eurozone crisis appears ever more intractable, the quantity of funds required to assist Mediterranean sovereigns to balance their books appears ever more stratospheric. Bailouts can work only if, in the long term, economic growth creates tax revenues to repay the bailouts.

Now that even the German economy appears flat, the process of perennial bailouts may become unrealistic. The market consequences of a Eurozone economy defaulting on its sovereign debt obligations would be so severe that a country might seek to exit the Euro, revert to a purely domestic currency and devalue through printing money. Through a Euro exit, formal default can be averted and "austerity", the dramatic government budget cuts imposed by the European Union on bailout fund recipients that threaten the democratic survival of incumbent governments in affected countries, can be avoided. It is hard to say if and when such an exit might occur. But if it does, then one thing can be assured: it will be a surprise. For if word of such an event were leaked in advance it could not work. The early news would precipitate a bank run, which in turn would necessitate an immediate public commitment not to exit the Euro. Hence Euro exit plans must be concocted amidst the utmost secrecy.

What would happen to assets held in a country that exits the Eurozone, were this to occur? This is a vexed question. However there is a remarkably close precedent from the recent past, namely Argentina. During the course of that country's financial crisis in 1999-2002, the country went through a process of *"Pesification"*. The Argentine Peso had previously been pegged to the US Dollar and it was normal for international contracts, particularly those

signed with government entities, to be denominated in US Dollars. When the peso was decoupled from the Dollar by the Argentine central bank, legislation was enacted converting the currencies of those contracts to Pesos. US Dollar bank balances in domestic banks were likewise *"Pesified"*. People's savings were wiped out overnight, and contractual assets held by foreign investors were radically decreased in value. One can imagine much the same process in the event of a Eurozone exit. As scholars of international investment law are all too aware, these acts initiated a torrent of litigation against Argentina as a sovereign, the net result of which was condemnation of the Argentine government to pay many hundreds of millions of Dollars in compensation to foreign investors. Academic papers and PhDs are still being written about these events, and the legal doctrines developed as a result, over a decade later.

Unsurprisingly, Argentine domestic law was not the source of the relief which international investors sought as a result of the damage they had suffered by the Pesification policy. The Argentine government's position, enshrined in domestic legislation enacted at the time, was that the measures undertaken were strictly necessary in the face of Argentina's own sovereign debt crisis. Nevertheless investors with Argentine exposure had some other causes of action at their disposal. Under a network of bilateral investment treaties that Argentina had signed with a plethora of other nations, foreign investors had rights in international law not to have their investments expropriated without due compensation, nor to suffer "unfair" or "inequitable" treatment. These treaties had been signed between nations over several decades since the end of the 1950s, and were originally thought a form of soft law which promoted cross-border investment flows by exhorting states to treat foreign investments reasonably. But slowly these agreements introduced arbitration clauses, and in the 1990s investors started realising that they could sue sovereigns for breaching their commitments under the agreements.

The original formulations in the agreements had been prepared by diplomats and were characteristically vague: where does the standard of "fair and equitable treatment" start and end? Any investor may feel that anything adverse that happens to him is unfair. But under the watchful eyes of a growing army of international investment lawyers, these ambiguous formulations started being fleshed out. A series of differing categories of sovereign acts started to emerge as candidates for unfair or inequitable behaviour, one of which was legislative action adversely affecting a long-term investment that an investor could not reasonably anticipate might come to pass when making an investment. Under international investment law, sovereigns retain the prerogative to legislate; but their discretion is tempered by the obligation not to do so in such a way that undermines an investor's legitimate expectations.

A decision to change the currency in which a contract is denominated is an archetypal example of legislating in breach of an investor's legitimate expectations. A contract that may once have appeared profitable will suddenly cease to be so if the currency in which the contractor is to be paid is worth far less than that previously anticipated. Consider where a person has agreed a Euro-denominated contract with a European national counterpart or entity, or agreed with a European national bank to hold his account balance in Euros. The currency of that contract or account balance is suddenly converted to the local currency, which instantly tumbles on the international forex markets. It is then open to the foreign investor to say "I could never reasonably have been expected to take the risk of this happening". Hence, the investor may argue that he has not been treated fairly and equitably by the sovereign of the territory in which he has chosen to invest; and he may then raise an action for damages against the sovereign itself (not against his contractual counterpart) before an international investment tribunal.

Such was the experience of the Argentine government in the first decade of 2000, when dozens of claims of this nature were launched against Argentina under miscellaneous bilateral investment treaties. In each case the complaint was pesification of contracts and bank accounts. There are several observations to make about these claims. Firstly, many are still underway and the litigation process proved horrendously slow. The volume of claims almost brought ICSID, the branch of the World Bank charged with administering arbitrations under a number of bilateral investment treaties, to a crashing halt. Secondly Argentina has a comprehensive record of losing these cases badly. The sizes of awards entered against Argentina have been very large indeed, routinely amounting to sums in excess of US$100 million.

In public international law, the measure of damages awarded against a state for breach of its international obligations is known by practitioners as *"Chorzow Factory"* damages, after the famous case of the inter-war Permanent Court of International Justice, which involved German nationalisation of a Polish factory. It was held that Germany was liable to pay damages to wipe out the consequences of the illegal act, including all the profits anticipated from the factory's operation. This measure of damages is not too far from the common law measure of damages for tort (of "reasonably foreseeable" loss), save that in international investment law "pure economic loss" (i.e. lost profits) is recoverable whereas the English law of tort does not generally permit this head of recovery. The typical method of quantifying damages applied by investment tribunals is the discount cash flow method, in which the total future profit from an investment is calculated on the basis of the best assumptions available and then discounted for advance receipt and inflation. Unprofitable investments are not compensated. An investor's recovery is not the size of his lost investment; it is the size of his anticipated returns. The Argentina cases confirmed this principle with massive awards representing unrealised profits from, for the most part, a series of risky but potentially highly lucrative infrastructure investment contracts.

The other feature of the Argentina arbitrations that excited scholars and practitioners alike was the chaotic way in which the defence of a long-forgotten public international law defence of "necessity" was resurrected, recognised and then applied haphazardly. The idea underlying this defence is that in circumstances of dire national danger, a state may be justified in departing from its usual international obligations for reasons of exceptional exigency. This doctrine is profoundly controversial, entailing as it does a potentially unlimited excuse for states to depart from their treaty commitments in whatever circumstances they made deem exigent. Imagine if a state could depart from the laws and customs of war just because the war is particularly bitter; by the same analogy, imagine if a state could resile from its international economic commitments just because its economic situation is particularly bleak.

Even if a defence of necessity does exist in law, what conditions trigger it? How grave do things have to be? And who decides how grave – the state, or the arbitrators (who may not have sufficient specialist knowledge to decide the issue), or some third party expert, and if so which one? It is also argued that even if departure from international legal obligations is excusable under circumstances of necessity then there must be some constraints on the extent of the departure; and one of those constraints is that all parties are treated fairly and equitably. Hence the international legal standard by which Argentina was condemned could in any event not be eviscerated by the defence of necessity, were it to exist. None of these issues have so far been definitively resolved in the case law.

It would be naïve to assume the legal debate over these issues will not recur should Greece, Spain, Portugal or another country be pushed into an exit scenario through domestic political pressure following EU and IMF-imposed austerity preconditions for a bail-out. If Argentina's conversion of contracts and account balances into a different currency was a breach of investors' legitimate expectations, it is hard to see how an EU Mediterranean state's parallel actions in abdicating from the Euro would not have the same legal consequence. Indeed the case is all the more compelling, given that its founding instruments entail the permanent nature of the Euro as a currency and that EU legal documents are silent on provisions for departure from it.

The question of necessity will also recur, as legal debates draw striking parallels with the political. Should a Euro-state exit the Euro, is that the fault of the national government for failing its austerity commitments or of the international community for pushing them too hard? Was the alternative – sovereign default – really an impossible outcome which excuses departure from the state's international obligations? Who is to decide these questions of judgment: the democratically elected government, or an unelected international arbitration tribunal? Would an exit event destroy the network of international investment law in its entirety, by triggering so grave a raft of claims that the international community subsequently decided to tear the system up?

There is another feature of particular interest to international investors contemplating bringing a claim arising out of any country's exit from the Euro. Argentina has never paid a cent of any of the awards entered against it arising from its 1999-2002 financial crisis. It ringfenced its assets in-country. Enforcement

proceedings in other jurisdictions are attempted, but so far none has been successful. Argentina's foreign assets are now confined to diplomatic premises, which are inviolable. This has hampered the Argentine government's room for financial manoeuvre, and has gone some way to undermining confidence in the system of international investment law. Nevertheless the majority of awards entered against states by international investment tribunals are satisfied. It seems unlikely that a Euro-exit defaulting sovereign could insulate its international assets as effectively as the Argentine government achieved. The European economies are too interlinked for that. So more may ride on a new wave of post-Euro exit international investment claims: the awards may be eminently enforceable and the size of them may present a new existential danger to the integrity of the European Union.

Should the EU not hold the Euro together, come what may, then the rocky crags ahead are not just economic and political; they are legal as well.

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