A 'NECESSARY' RETHINK: INVESTOR-STATE ASYMMETRY IN INTERNATIONAL INVESTMENT AGREEMENTS

-Anirud Raghav S.U

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I. INTRODUCTION

The jury is still out on whether the Investor-State Dispute Settlement (ISDS) is a bane or a boon. Some argue it is a bane, because it curbs the regulatory latitude of the State, while others argue it is a boon because it can shield the investor from the arbitrary acts of the State.[1] Between these two narratives, it is important to realize that it is not the inherent nature of ISDS that makes it a bane or a boon; rather, a lot turns on the context of the investment – the investor, the state, the political clime, the industry *inter alia*. While we should remain conscious of the context, it is true that ISDS been criticized for curbing the regulatory freedom of the State.[2] Undoubtedly, the effectiveness of any International Investment Agreement ("IIA") depends on how adversely it impacts the State's regulatory freedom.

In this context, I examine the power imbalance between Investors and States by looking at cases in which the defence of necessity has been raised by the State. I argue that the trend has been towards prioritizing the Investor over the State. As such, I conclude that IIAs have unduly encroached on the State's regulatory space.

I make this analysis in three parts. *First*, I expound on the necessity defence in International Law – its rationale, significance and why it can be used as a lens to test the balance of power vis-à-vis investors and States. *Second*, I examine the jurisprudence on the necessity by looking at the leading authorities on the subject. I conclude that necessity holds the State to an unreasonably high standard of proof and show the damaging policy consequences of this situation. *Third*, I situate the necessity defence in the context of the larger issue of policy space being eaten up by IIAs. I suggest one central reform to restore the essence of necessity defence: a proportionality analysis, as opposed to a technicality based, narrow analysis.

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[1] Prabhash Ranjan, *Investor-State Dispute Settlement (ISDS) Cases and India: Affronting Regulatory Autonomy or Indicting Capricious State Behaviour?* 21 Journal of International Trade Law and Policy 42, 44 (2022).
[2] *See* Suzanne A. Spears, The Quest for Policy Space in a New Generation of International Investment Agreements, 13 J. Int'l Econ. L. 1037 (2010); *See also* Kyla Tienhaara, *Regulatory Chill in a Warming World: The Threat to Climate Policy Posed by Investor-State Dispute Settlement*, 7 TEL 229 (2018); *see also* Chester Brown & Kate Miles, Evolution in Investment Treaty Law and Arbitration 615 (Camridge University Press 2011).

II. SETTING THE CONTEXT: NECESSITY DEFENCE IN INTERNATIONAL LAW

The necessity defence in international law is akin to the defence of necessity in other contexts – it is based on the premise that necessity knows no law.[3] The necessity defence is a *justification*, not a ground, for a wrongful act.[4] Often, cases concerning necessity are complex – the defendant pleads necessity, but harm has already been caused to the plaintiff. So, how should the law (that purports to protect the plaintiff) treat such a situation? Should the defendant be asked to compensate the plaintiff? If so, how should the law respond to the defendant's claim that the sheer *necessity* of the situation rendered all other possibilities (other than the "wrongful" act) impracticable? In such cases, the law faces a choice between two evils, and grants the State the benefit of the doubt where its interest is deemed superior.[5]

The defence of necessity is codified in Article 25 of the International Law Commission's Responsibility of States for Internationally Wrongful Acts.[6] Article 25 lays down the following conditions to satisfactorily raise the necessity defence: a) the allegedly wrongful act was the *only way* in which the state could safeguard an essential interest against a *grave and imminent peril*; b) It should not *seriously impair* the aggrieved party's essential interest; c) The invoking State shall not have *contributed* to the situation of necessity; d) the wrongful act should not violate any peremptory norm of international law.

The necessity defence is significant primarily because it is the last, and perhaps most forceful resort the state has, to justify its wrongful act. Necessity acts as a mediator between performing obligations incurred under the IIAs and safeguarding the State's essential interests, which would be gravely affected if the performance were enforced. It is possible to judge the balance of power between Investors and States just from the way tribunals have treated the necessity defence, since claims of necessity predominantly engage the public interest directly. If the tribunals find in favour of the investor despite acknowledging public interest, it implies a subordination of public interest to the investor's rights, which makes it clear where balance of power tilts. At this juncture, we may look at a few cases where this exact choice was made.

III. NECESSITY IN PRAXIS: INVESTOR RIGHTS OVER STATE INTEREST?

I seek to show that the necessity defence has been applied narrowly in a way that *first*, defeats the very point of the defence and *two*, prejudices the State by dismissing their claims on ill-defined criterion. Here, I will primarily be dealing with two leading cases that illustrate the narrow, methodical application of the necessity defence. I picked these two cases, since they are credited with setting the tone for understanding necessity and involve a tussle between urgent regulatory decisions to be made by the states, and their commitments under IIAs.

A. Gabčíkovo-Nagymaros Project - The Mother of all Problems.

The *Gabčíkovo-Nagymaros Project* (Hungary/Slovakia)[7] case has set the stage for understanding necessity. This is one of the few cases in which the tribunal delves into the defence of necessity, lays down its various prongs and applies it. In this case, Hungary abandoned a riverbed project it had committed to perform under its BIT with Slovenia. To

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[3] *Federica Paddeu & Michael Waibel, Necessity 20 Years On: The Limits of Article 25*, 37 ICSID Review - Foreign Investment Law Journal 160, 184 (2022).
[4] *See* id. at 163.
[5] *See* id. at 162; Larry Alexander, *Lesser Evils: A Closer Look at the Paradigmatic Justification*, 24 Law & Philosophy 611 (2005).
[6] Responsibility of States for Internationally Wrongful Acts, Art.25 (2001).
[7] *Gabčíkovo-Nagymaros Project* (Hungary/Slovakia), Judgment, 1997 I.C.J (25th September), https://www.icj-cij.org/sites/default/files/case-related/92/092-19970925-JUD-01-00-EN.pdf.

justify this violation, it claimed ecological necessity – there was tangible reason to believe that, given the topography of Hungary, if the project were performed, it would gravely threaten the drinking water sources, as well as the environment at large.[8] The court immediately confirms this danger, taking notice of the scientific evidence adduced in support thereof.[9] Notice here that the court acknowledges that ecological necessity is indeed an essential interest that Hungary is seeking to protect. Moreover, the court notes that the issue was of a pressing and imperative nature, noting the enormous public interest involved.[10] But here on, things start getting curious – the court offers two vague reasons to reject the necessity defence.

First, after noting the sheer gravity of the peril, the court says that the peril was not "imminent" enough.[11] Even taking the finding to be true on fact, the corollary is startling – despite the peril being considerably grave, the country must wait for the peril to become imminent to act under necessity. If this standard should apply, states cannot safeguard themselves against grave perils simply because they are likely to materialize sometime in the future. To make matters worse, precisely *how imminent* the peril must be was a question left unanswered. Few conditions impinge on the regulatory realm of the state as much as the condition of *imminence* does.

Second, the court says there were other alternatives.[12] Prima facie, this reason seems fair. But if we read closely, the court says the very existence of another alternative, regardless of how expensive it is, is enough to frustrate the claim of necessity.[13] The court here suggests that river water, through purification, could be processed to supply drinking water to Budapest. A line later, it admits how expensive such a measure might be.[14] Nonetheless, based on this "alternative possibility", it was held that the "only way" condition was violated. Yet again, the policy corollary is this: in almost any situation, with the benefit of hindsight, it is possible to come up with several alternative measures especially if time and cost were not constraints. Given this limitation, how is any country claiming necessity to succeed? One would assume that the court goes into the balancing stage of the analysis – weighing the interests and assessing which was relatively more prejudiced. The court however says that since the test is "cumulative" – failing the *only way* condition meant that the whole defence was invalidated, precluding the need to go into the balancing stage.[15] Considering the unreasonable burden imposed by the *only way* condition, one can be rest assured that few cases, if ever, will pass this test.

B. *CMS v. Argentina* – The Problem Intensifies.

We now turn *to CMS v. Argentina*,[16] occurring in the backdrop of the Argentinian financial crisis 1998-2002. CMS, a US corporation, owned a 30% stake in TGN, an Argentinean gas transportation company. When Argentina faced an economic crisis, it revoked TGN's rights to set tariffs in US dollars and make inflation adjustments. This devaluation caused TGN's profits to plummet and CMS sought $261 million in compensation for the loss in the value of its TGN shares, citing violations of the Argentina-US BIT. It alleged violation of the Fair and Equitable Treatment clause (FET). The court, once again noting the severity of the financial crisis (and

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[8] id. ¶ 54.
[9] id.
[10] id. ¶ 55.
[11] id. ¶ 57.
[12] id.
[13] id ¶ 55.
[14] id.
[15] id. ¶ 51.
[16] *CMS Gas Transmission Company v. The Argentine Republic*, ICSID Case No. ARB/01/8, Award (12th May 2005), https://www.italaw.com/sites/default/files/case-documents/ita0184.pdf.

thereby impliedly noting the major public interest involved), proceeds to offer two untenable reasons to deny the necessity defence.

First, the court strictly applied the "only way" standard – that the impugned measure taken must be the only way of dealing with the situation. Akin to *Nagymaros*, it followed a strict construction and said that it was immaterial how costly the alternative was, as long as there was one.[17] The court here relied on the assessments of economic experts to say that there was indeed another way. My abovementioned criticism of the mechanical application of this rule stands – the odds are virtually stacked against the State. The benefit of hindsight, access to expert opinion post-facto, non-consideration of time and cost as a constraining factor taken together invariably means there will have been another way out.

Second, court notes that the financial crisis was endogenous, i.e, caused by Argentina itself, and thus violated the condition that Argentina should not have caused it.[18] There is a normative as well as methodological critique of this rule. First, normatively, it is unclear why the question of whether the State contributed to the necessity is relevant if there is indeed a state of necessity. No state would voluntarily drag itself into an exigent situation merely to take advantage of the defence. Second, methodologically, it is uncertain what is the standard of robustness that should be applied to decide "contribution". Notwithstanding these questions, the court refused to appreciate the importance of regulatory flexibility during a financial crisis and decided against Argentina.

It is curious that the court should acknowledge that essential interests were involved here yet decide based on vaguely defined conditions. One cannot blame the tribunal for being bound by vague laws; yet surely it is within the tribunal's power to note these concerns and take a balanced approach.

C. In Sum – Issues with the Necessity Defence.

In sum, the interpretation of Article 25 leaves much to be desired. *First,* the requirement that the allegedly wrongful act be the "only way" that the State could've managed the situation is an unreasonably high burden, even for necessity. It would be easy to prescribe alternatives; but in the sum totality of the situation, would these alternatives have been practically implementable? *Second,* this provision is vague on many counts. What is the content of the "only way", provision? How imminent does the threat have to be? Is this a conjunctive or a disjunctive test? What standard of robustness should be applied to *contribution*? These questions are of ongoing interest. *Third,* in limb (c), what standards of causation or foreseeability must be used to determine the extent to which the state contributed to its situation of necessity. Do not all situations of necessity arise from an intricate web of events? Moreover, the current position is that the "only way" standard is very strictly construed by tribunals and most defences fail here.[19] Nevertheless, the above cases show that it is easy for the provision to be turned on its head. While it is beyond the scope of this paper to offer a detailed critique of the necessity defence, it serves to contextualize a discussion on the *imbalance of power* between the Investor and the State.

IV. SKEW IN FAVOUR OF THE INVESTOR: CONCLUSION AND WAY FORWARD

[17] id. ¶ 329.
[18] id.
[19] Paddeu & Waibel, *supra* note 3, 162.

The necessity defence is rarely invoked,[20] probably because experience shows us that States must discharge a high burden.[21] But in cases where it is invoked, the tribunal must adopt a holistic, all-things-considered approach, as opposed to its current practice of dismissing cases on ill-defined criteria like *imminence*, *only way* and *contribution*. The absence of robust standards only calls for caution in applying these standards considering the gravity of public interest typically involved in these cases. Note that my claim is not simply that the necessity defence has virtually become dead letter – it is that necessity has shed light on what the tribunals have prioritized between investors and states in IIAs, i.e, the investors.

The above two cases have one commonality – in both cases, the court acknowledges that there was an essential state interest involved. Where there is an essential state interest involved, it follows that regulatory interventions become imperative. However, court's narrow interpretation of the necessity defence has curtailed the State's regulatory powers in exigent circumstances. Thus, even in conditions of exigency, State's regulatory freedom has been made secondary to the Investment Agreement.

International Investment Agreements' appeal has thus been limited by its encroachment on the State's regulatory freedom. In response to the shortcomings of the necessity defence, parties are now inserting Non-Precluded Measures (NPM) clauses. NPMs usually make the State's obligations subject to certain conditions internally stipulated in the treaties. For instance, an NPM clause might excuse the State's performance where public order or security of the State is threatened. This tries to overcome the vagueness inherent in Article 25's necessity defence. Nonetheless, concerns surround NPMs as well.[22]

It is time we ask ourselves whether the structure of IIAs needs a fundamental rethink. Indeed, I am aware that I cannot let only the necessity defence overdetermine the true balance of power between Investors and States in IIAs. But the necessity episodes make one thing clear – the benefit of the doubt lies with the Investor, even in cases where the State's public interest is admittedly involved. The defence has time and again failed to truly protect the State's interest, thanks to the vagueness and fixation over technicalities. Here, one reform may be suggested: give more weight to a proportionality analysis. As I have noted above, the courts have made certain technical considerations like "only way" or "imminence" the be all or end all. Instead of this approach, I suggest that it would be much more profitable to give primary consideration to a proportionality analysis – weighing the interests involved and comparing the relative harm sustained by the parties. Note that this test is not foreign; it is very much within the framework of Article 25 (specifically, limb (b) noted in Section II). Adopting a proportionality analysis will allow the court to engage directly with the public interest element and weigh it against the interests of the investor, thereby restoring the essence of the defence. In sum, I suggest that a proportionality analysis should be the primary guide to the decision of the court, while other factors like "only way" or "imminence" must be supplementary factors. This framework will

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[20] *See* Paddeu & Waibel, *supra* note 3, 162 illustrating that necessity claims were raised primarily during the Argentine Financial Crisis, in the context of war, revolutions, national security crises or public order and security.
[21] *See,* for instance, *Bernhard von Pezold and Others v Republic of Zimbabwe*, ICSID Case No ARB/10/15, Award (28 July 2015); *See also JKX Oil & Gas plc, Poltava Gas BV and Poltava Petroleum Company JV v Ukraine*, UNCITRAL, Award (6 February 2017) (unpublished) where Ukraine raised necessity with regards to the Crimean crisis. The Tribunal rejected the measures, citing it that it was not the "only way".
[22] *See* Mark McLaughlin & Dilip Pathirana, *Non-precluded Measures Clauses: Regime, Trends, and Practice*. Handbook of International Investment Law and Policy (2020); *See also* William W. Burke-White & Andreas von Staden, I*nvestment Protection in Extraordinary Times: The Interpretation and Application of Non-Precluded Measures Provisions in Bilateral Investment Treaties*, 48 VA. J. Intl'l L. 307, 409 (2008).

go to the heart of what is in dispute – the State's public interest and the investor's interest. Yet, this is only a small step in the larger goal of setting the Investor-State asymmetry right.