State of Necessity: Effect on Compensation

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I. Introduction

This paper discusses the effect on compensation of the state of necessity, one of the so-called "circumstances precluding wrongfulness". For some, it would seem obvious that if wrongfulness of an act is excluded, an obligation to pay compensation for the losses caused by this act is also excluded. However, perhaps counter-intuitively, this is not necessarily the case under international law. The issue is relatively novel and there is little clarity as to what exactly the law requires and how it should be applied in the investment context.

State of Necessity

In international law, the state of necessity, as well as other "circumstances precluding wrongfulness",[2] is deemed to excuse the wrongfulness of conduct that would otherwise be inconsistent with international obligations of the State concerned.

"State of necessity" refers to situations where a State's sole means of safeguarding an essential interest threatened by grave and imminent peril is to adopt conduct inconsistent with its international obligation to another State. Article 25 of the ILC Articles on State Responsibility ("ILC Articles") has come to be considered as the

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[2] The ILC Articles on State Responsibility set out six circumstances precluding wrongfulness: Consent (Article 20); Self-defence (Article 21); Countermeasures (Article 22); *Force majeure* (Article 23); Distress (Article 24); and Necessity (Article 25).

embodiment of customary international law on necessity.[3] ILC Article 27, discussed in detail below, determines the consequences of successful invocation of the necessity defence (as well as of other circumstances precluding wrongfulness).

In investment treaties, the necessity-type provisions are not very common but a number of countries have included them in their BITs. It is disputed whether provisions of this kind are on the same footing with the customary rules on necessity, and whether the consequences of their successful invocation are the same as under customary law. These questions are explored below.

Relevant investment awards

Several recent arbitral awards, as well as one decision of the ICSID Ad Hoc Annulment Committee, have addressed the question of compensation in cases of successful invocation of the necessity defence.[4] The relevant cases – with Argentina as respondent in all of them – are very similar: they arose from the same factual background, under the same Argentina-US BIT, and with the claimants in all the cases challenging the same measures taken by the Argentinean Government. The cases were

[3] Article 25 of the ILC Articles on State Responsibility provides:

Article 25
Necessity

1. Necessity may not be invoked by a State as a ground for precluding the wrongfulness of an act not in conformity with an international obligation of that State unless the act:
   (a) Is the only way for the State to safeguard an essential interest against a grave and imminent peril; and
   (b) Does not seriously impair an essential interest of the State or States towards which the obligation exists, or of the international community as a whole.
2. In any case, necessity may not be invoked by a State as a ground for precluding wrongfulness if:
   (a) The international obligation in question excludes the possibility of invoking necessity; or
   (b) The State has contributed to the situation of necessity.

[4] *CMS Gas Transmission Company v The Argentine Republic* ("*CMS v Argentina*"), ICSID Case No. ARB/01/8, Award of 12 May 2005, Decision on the Application for Annulment of 25 September 2007; *Enron Corporation and Ponderosa Assets, L.P. v Argentine Republic* ("*Enron v Argentina*"), ICSID Case No. ARB/01/3, Award of 22 May 2007; *LG&E Energy Corp., LG&E Capital Corp., LG&E International Inc. v Argentine Republic* (*LG&E v Argentina*), ICSID Case No. ARB/02/1, Decision on Liability of 3 October 2006, Award of 25 July 2007; *Sempra Energy International v Argentine Republic* ("*Sempra Energy v Argentina*"), ICSID Case No. ARB/02/16, Award of 28 September 2007.

brought by US shareholders in Argentinean gas transportation and distribution companies which had suffered economic losses as a result of measures introduced by the Government during the severe economic crisis of the early 2000s. The said measures effectively dismantled the favourable regulatory framework that had been created by the Argentine Government in the early 1990s to attract foreign investment in the gas transportation and distribution sector.

In all cases, Argentina's measures were found to be in breach of its BIT obligations. Argentina raised the "state of necessity" defence under both customary international law and the BIT arguing that, in the circumstances of the economic emergency, its measures had been necessary to maintain public order and protect the essential interests of the State. While in *CMS*, *Enron* and *Sempra Energy*, the tribunals rejected the necessity of Argentina's measures for not cumulatively meeting all the required conditions set by customary international law, the defence was allowed in the *LG&E* case under both the BIT and customary law.

The relevant point for this analysis is what effect the acceptance of the necessity defence has on the award of compensation. At this point in time, this question does not have a clear-cut answer; the law on this matter is unsettled. The answer may depend on whether the necessity defence is invoked under customary international law or under an investment treaty. Customary international law is discussed first (Section II); treaty regimes, using the Argentina-US BIT as an example, are examined next (Section III). Additional considerations addressing a number of relevant points (Section IV) are followed by conclusions (Section V).

II. Customary International Law

Under customary international law, the state of necessity (and other circumstances precluding wrongfulness) does not annul or terminate the international obligation concerned; rather it provides a justification or excuse for non-performance while the circumstance in question subsists.[5] The ICJ pointed out in the *Gabčíkovo-Nagymaros*

[5] Commentary to the ILC Articles, Chapter V of Part I, para.2

Project case that "[a]s soon as the state of necessity ceases to exist, the duty to comply with treaty obligations revives."[6] This means that, as a matter of State responsibility, there is a duty to provide reparation for damage caused by the State *outside* the period of necessity. The question is whether there is also an obligation to compensate – after the emergency ceases to exist – for damage suffered by a claimant *during* the period of emergency. There are two important considerations in this regard.

On the one hand, it is indisputable that the successful invocation of the necessity defence means that the measures taken by a State, even though in breach of a certain international obligation, are excusable under international law and, as such, cease to be wrongful (hence the term "circumstances *precluding* wrongfulness"). In the absence of an internationally wrongful act, there can be no obligation to provide reparation. This is confirmed by the judgement of the ICJ in the *Gabčíkovo-Nagymaros Project* case, where Hungary contended that the wrongfulness of its conduct in breach of the treaty obligations was precluded by necessity. The Court stated:

> [A] state of necessity […] may only be invoked to *exonerate from its responsibility* a State which has failed to implement a treaty.[7]
>
> The state of necessity claimed by Hungary – supposing it to have been established – […] would only permit the affirmation that, under the circumstances, Hungary *would not incur international responsibility* by acting as it did.[8]

On the other hand, ILC Article 27 provides:

> **Article 27**
> **Consequences of invoking a circumstance precluding wrongfulness**
>
> The invocation of a circumstance precluding wrongfulness in accordance with this chapter is *without prejudice to*:
>
> […]
>
> (*b*) *The question of compensation for any material loss caused by the act in question*.
>
> (emphasis added)

[6] *Gabčíkovo-Nagymaros Project (Hungary/Slovakia)*, *I.C.J. Reports 1997,* p.7, p.39, para.47.

[7] *Ibid*. (emphasis added).

[8] *Ibid.*, p.39, para.48 (emphasis added).

The formulation adopted in ILC Article 27 on the matter of compensation is soft – "without prejudice […] to the question of compensation". There is no explicit *requirement* to provide compensation in all circumstances; rather, compensation is not excluded automatically, even though the act in question ceases to be wrongful.[9]

In principle, an obligation to pay compensation for the damage caused by *lawful* acts is not alien to the international law of foreign investment. The prime example is expropriation, which, even if effected for a public purpose (i.e., similar to necessity, in pursuit of State interest), invariably entails a payment of compensation. Even though not fully settled, international law is clear that lawful expropriation should be accompanied by the payment of compensation, usually equivalent to the market value of the assets taken. International law on compensation for the damage caused under the circumstances precluding wrongfulness is much farther from being settled.

Uncertainty Created by the ILC's Lack of Clarity

The soft, non-mandatory character of Article 27 was emphasized in the *CMS* Annulment Decision and in the *LG&E* Award.[10] The *LG&E* Tribunal observed that the Article was not specific on whether any compensation was payable to the party affected by losses, on the kind of losses that could be compensated for, and on the circumstances in which compensation should be payable.[11]

In its commentaries to Article 27, the ILC specified that the term "compensation" carried a special connotation in this provision, and was different from compensation as a form of reparation for internationally wrongful acts. The Commission stated that

[9] Interestingly, during the ILC debate on the draft text of Article 27 (at that time, Article 35), a view was expressed that "the main consequence of invoking a circumstance precluding wrongfulness was that no compensation was due, inasmuch as the normal consequences of a breach of obligation had been ruled out". It was suggested that the article "thus dealt with exceptional consequences rather than consequences in general". (See *ILC Yearbook* 1999, Vol. II(2), p.85, para.409).

[10] *CMS v Argentina*, Decision on the Application for Annulment of 25 September 2007, para.147; *LG&E v Argentina*, Decision on Liability of 3 October 2006, paras.260, 264.

[11] *LG&E v Argentina*, Decision on Liability of 3 October 2006, paras.260, 264.

"[a]lthough article 27 (b) uses the term 'compensation', it is not concerned with compensation within the framework of reparation for wrongful conduct, which is the subject of article 34. Rather it is concerned with the question whether a State relying on a circumstance precluding wrongfulness should nonetheless be expected to make good any material loss suffered by any State directly affected."[12] The ILC also stated that "[t]he reference to 'material loss' is narrower than the concept of damage elsewhere in the articles: article 27 concerns only the adjustment of losses that may occur when a party relies on a circumstance covered by chapter V ['Circumstances precluding wrongfulness']". This may be read to mean that consequential damages, even if established, do not come within the scope of Article 27.[13]

Thus, under the ILC's approach, once wrongfulness of a measure is excluded, compensation as a form of reparation cannot be required. At the same time, certain compensation for the material loss may be provided despite the absence of wrongfulness. The ILC's approach may be justifiable as a matter of pure legal logic, but as a practical matter, it appears somewhat confusing because it fails to draw a clear distinction between compensation for wrongful conduct and compensation for conduct that is excusable in terms of both the specific criteria triggering compensation and the appropriate measure and extent of compensation.

Determinant factor for the question of compensation

In the Commentaries, the ILC noted that there exists a "possibility of compensation in certain cases" but "it is not possible to specify in general terms when compensation is payable".[14] The ILC attributed its lack of precision to the fact that "the range of possible situations covered by chapter V is such that to lay down a detailed regime for compensation is not appropriate".[15]

[12] Commentary to ILC Article 27, para.4.

[13] One other interpretation could be that the right to compensation is simply suspended for the duration of the state of necessity, but would be revived thereafter. In reality, however, given the relatively short emergency periods and prolonged dispute settlement procedures, this temporary suspension of the obligation to compensate would not have any practical value for responsible States.

[14] Commentary to ILC Article 27, para.1.

[15] *Ibid*., para.6.

Regarding the criteria to distinguish between situations where compensation is due and situations where it is not, it follows from ILC's preparatory works that the distinction should depend on whether it would be legitimate to allow a State "to shift the burden of the defence of its own interests or concerns on to an innocent third State".[16] Under this approach, it appears that when the third State is indeed innocent, it must not bear the burden of the State acting in protection of its own interests, and thus compensation should be provided. Conversely, if a third State had a role to play in the creation of a problematic situation, then there is no room for compensation.

On this basis it was suggested that there should be no compensation in cases where the circumstances of self-defence or countermeasures are invoked, "since those circumstances depend upon and relate to prior wrongful conduct of the 'target' State, and there is no basis to compensate it for the consequences of its own wrongful conduct".[17] At the same time, it was noted that "there is a strong case for compensation for actual loss where a State relies on necessity, provided at least that the other State has not itself through its own default or neglect produced the situation of necessity".[18] The same conclusion was reached in relation to distress.[19]

Investment tribunals have also recognized that the task of appropriate apportionment of the burden of loss plays an important, perhaps determinative, role in deciding the question of compensation. Thus, the *CMS* Tribunal stated that it would be contrary to the treaty if one party, or its subjects, were to "bear entirely the cost of the plea of the essential interests of the other Party".[20] The *LG&E* Tribunal, when deciding that no

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[16] J. Crawford, Special Rapporteur, *Second Report on State Responsibility*, *Addendum*, (A/CN.4/498/Add.2), 30 April 1999, paras.339, 346. See also Commentary to ILC Article 27, para.5 and the summary of the ILC debate in *ILC Yearbook* 1999, Vol. II(2), p.85, para.408.

[17] J. Crawford, Special Rapporteur, *Second Report on State Responsibility*, *Addendum*, A/CN.4/498/Add.2, 30 April 1999, para.342. The same conclusion was reached in respect of consent as a circumstance precluding wrongfulness, unless the consent is "conditional on the payment of a fee, or rental, or compensation for harm incurred" (*ibid*.), and *force majeure* (*ibid*., para.343).

[18] J. Crawford, Special Rapporteur, *Second Report on State Responsibility*, *Addendum*, A/CN.4/498/Add.2, 30 April 1999, para.343.

[19] *Ibid.*, para.344.

[20] *CMS v Argentina*, Award of 12 May 2005, para.390.

compensation was due, used the following formulation: "this Tribunal has decided that the damages suffered during the state of necessity should be borne by the investor."[21]

It is also indicative that even in cases where the necessity was not accepted, the tribunals still reduced compensation on account of Argentina's economic crisis, thereby distributed the loss between the parties. Specifically, the *CMS* Tribunal noted that while it would be wholly unjustifiable to put all the costs of the crisis on the claimant, the claimant could not be entirely beyond the reach of the abnormal conditions prompted by the crisis.[22] In the Tribunal's view, some of the negative impacts should be attributed to the business risk borne by *CMS* when investing in Argentina. The Tribunal said that both parties should be "sharing some of the costs of the crisis in a reasonable manner", otherwise the arbitral award could "amount to an insurance policy against business risk".[23] Specifically, the adverse economic circumstances were taken into account in determining the market value of the shares using discounted cash flow analysis (DCF).[24]

Similarly, the *Enron* Tribunal noted that "just as it is not reasonable for the licensees to bear the entire burden of such changed reality neither would it be reasonable for them to believe that nothing happened in Argentina since the License was approved".[25] The *Enron* Tribunal also made downward adjustments in its DCF valuation of the investment to "reflect the reality of the crisis" as compared to a "normal business scenario".[26] The Tribunal in *Sempra Energy* followed the route of *CMS* and *Enron* in this respect.[27]

Agreement between the parties concerned

[21] *LG&E v Argentina*, Decision on Liability of 3 October 2006, para.264.

[22] *CMS v Argentina*, Award of 12 May 2005, para.244.

[23] *Ibid.*, para.249.

[24] *Ibid.*, paras.443-446.

[25] *Enron v Argentina*, Award of 22 May 2007, para.232.

[26] *Ibid.*, para.407.

[27] *Sempra Energy v Argentina*, Award of 28 September 2007, paras.397, 416-449.

The ILC also noted that it would be "for the State invoking a circumstance precluding wrongfulness to agree with any affected States on the possibility and extent of compensation payable in a given case."[28] However, the Commission did not comment on what would be the consequences of the inability of the States concerned to reach an agreement on this matter.

It is improbable that the absence of an agreement on "the possibility and extent of compensation" (or even of the attempt of negotiations) between the States concerned can prevent a tribunal from deciding the question of compensation. For instance, the *CMS* and *Enron* tribunals – having registered the absence of an agreement between the States concerned on the amount of compensation – stated that they would proceed to determine the amount of compensation themselves.[29]

III. Treaty Regimes

Some investment treaties contain clauses that resemble the necessity defence under customary law. Article XI of the Argentina-US BIT, considered in a number of investment disputes, will be used as an example in this analysis. Additionally, another type of treaty clause, sometimes referred to as an "armed conflict clause" is reviewed below.

A. Treaty Necessity Clauses

Article XI of the Argentina-US BIT provides:

> This Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.

[28] Commentary to ILC Article 27, para.6.

[29] Note, however, the logical mistake admitted by both Tribunals: despite what they said, they proceeded in fact to determine compensation as a form of reparation for wrongful acts, rather than compensation due in the circumstances precluding wrongfulness (both *CMS* and *Enron* tribunals rejected the necessity defence).

It is disputed whether the provisions of this kind are on the same footing with the rules on necessity under customary international law, and whether the consequences of their successful invocation are the same as under customary law.

No compensation?

The ICSID Ad Hoc Annulment Committee in the *CMS* case held that Article XI of the Argentina-US BIT and rules of customary international law on necessity (reflected in ILC Article 25) were "substantially different" in their "operation and content". The Annulment Committee held that the *CMS* Tribunal had made a manifest error of law by assimilating the two articles.[30]

On the question of compensation, the *CMS* Annulment Committee concluded that the *CMS* Tribunal made another manifest error of law by conflating the *consequences* of successful invocation of the necessity defence under customary international law and under the BIT. In Committee's view, such consequences would have been different depending on the law applied. The Committee suggested that Article XI, if successfully invoked, necessarily absolved the respondent from an obligation to pay compensation:

> Article XI, if and for so long as it applied, excluded the operation of the substantive provisions of the BIT. That being so, there could be no possibility of compensation being payable during that period.[31]

It appears that the Committee treated Article XI as a stand-alone provision sufficient in its content to resolve the question of compensation, without resorting to customary international law.

The earlier *LG&E* award falls in line with the Annulment Committee's approach. The *LG&E* Tribunal ruled that having successfully invoked the state of necessity under

[30] *CMS v Argentina*, Decision on the Application for Annulment of 25 September 2007, paras.128-131.

[31] *Ibid.*, para.146. Given its extremely limited mandate, the Committee decided that it could not annul the erroneous findings of the original Tribunal.

Article XI of the BIT, Argentina was exempted from liability during the period of necessity (from 1 December 2001 to 26 April 2003) and was only liable for damages caused by the measures at issue before and after the period of necessity.[32] In reaching this conclusion, the Tribunal relied on Article XI of the BIT, which, in the words of the Tribunal, "establishe[d] the state of necessity as a ground for exclusion from wrongfulness of an act of the State, and therefore, the State [was] exempted from liability."[33] In the Damages Award that followed, the *LG&E* Tribunal compensated for the loss of dividends suffered by the claimants since the introduction of the first measure at issue in August 2000 but excluded from the awarded amount the "would-be" dividends that had been lost during the established period of necessity. Compensation was reduced by US$ 28.8 million on this account.[34]

Or compensation determined by customary law?

The *Sempra Energy* award, issued only three days after the *CMS* Annulment Decision, does not seem to share the latter's approach. The *Sempra Energy* Tribunal, after engaging in a rather detailed analysis of the relationship between Article XI of the BIT and ILC Article 25, held that because Article XI of the Treaty did not determine the precise conditions of its application, rules of customary law had to be applied as a subsidiary source of law:

> [T]he Treaty provision is inseparable from the customary law standard insofar as the definition of necessity and the conditions for its operation are concerned, given that it is under customary law that such elements have been defined.[35]

The Tribunal said it did not "believe that because Article XI did not make an express reference to customary law, this source of rights and obligations [became] inapplicable."[36] Continuing the Tribunal's logic, because Article XI does not identify

[32] *LG&E v Argentina*, Decision on Liability of 3 October 2006, paras.229, 259-265.

[33] *Ibid*., para.261.

[34] *LG&E v Argentina*, Award of 25 July 2007, paras.106, 108.

[35] *Sempra Energy v Argentina*, Award of 28 September 2007, para.376.

[36] *Ibid*., para.378. The Tribunal added: "International law is not a fragmented body of law as far as basic principles are concerned and necessity is no doubt one such basic principle."

the consequences of its application, these would also have to be determined under customary international law.

The Award in *Sempra Energy*, which implies that ILC Article 27 would govern the award of compensation regardless of whether the necessity defence is invoked under the BIT or under customary law, is thus in contradiction with the *CMS* Annulment Decision, which would reject the obligation to pay compensation if the necessity defence is accepted under the BIT.

Even in the absence of *stare decisis* in the ICSID system, the decision of the ICSID Annulment Committee is bound to have an important influence on future arbitrations. Nevertheless, it remains to be seen which view will prevail.

B. "Armed Conflict" Clauses

Under the rubric of necessity, a separate type of clause found in many BITs has been discussed. The clauses of this type concern compensation for losses suffered in the circumstances of armed conflicts, riots, insurrection, as well as "state of national emergency". This last circumstance makes such provisions relevant to situations of economic turmoil like the one experienced by Argentina in the early 2000s. Indeed, Article IV(3) of the Argentina-US BIT, a provision that is representative of the clauses of this type, was invoked by the Respondent in the Argentinean cases.[37] Article IV(3):

> Nationals or companies of either Party whose investments suffer losses in the territory of the other Party owing to war or other armed conflict, revolution, *state of national emergency*, insurrection, civil disturbance or other similar events shall be accorded treatment by such other Party no less favorable than that accorded to its own nationals or companies or to nationals or companies of any third country, whichever is the more favorable treatment, as regards any measures it adopts in relation to such losses." (emphasis added)

[37] See *CMS v Argentina*, Award of 12 May 2005, paras.333, 375-376; *Enron v Argentina*, Award of 22 May 2007, para.314-321; *LG&E v Argentina*, Decision on Liability of 3 October 2006, paras.243-244; *Sempra Energy v Argentina*, Award of 28 September 2007, paras.356-363). The *Enron* and *Sempra Energy* awards provide the most useful analysis.

The cited provision does not provide a ground for derogating from other treaty obligations. It only refers to the matter of compensation for losses suffered under certain listed circumstances. The Article does not *require* payment of compensation or set out any guidelines for measuring compensation;[38] it merely establishes the right of foreign investors to non-discriminatory treatment with respect to reparation for losses suffered. This effectively leaves the substantive question regarding compensation for such losses unanswered. Technically, this provision, if viewed in isolation, does not prevent a host State from deciding *not* to pay *any* compensation for losses suffered, as long as this decision is applied without discrimination to all affected nationals and companies, whether domestic or foreign.

Significantly, however, this provision must be considered not in isolation, but in conjunction with other obligations of States under international law. As discussed above, customary international law does not automatically exclude compensation, while treaty necessity clauses may be understood to have this effect. Inconclusive as it is, the law still implies that compensation may be due in certain circumstances. Notably, the "armed conflict" provisions do not add to, or detract from, the right to compensation for losses; they merely guarantee a foreign investor from a particular country that the treatment it will receive in terms of compensation for such losses will not be less favourable than that accorded by the host State to its own nationals or to foreign investors from other countries.[39]

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[38] Note, however, that some provisions of this kind, particularly in the BITs concluded by the UK, include a second part that *requires adequate* compensation for certain types of losses. For example, Article 4(2) of the Bahrain-UK BIT (1991) provides:

> (2) Without prejudice to paragraph (1) of this Article, nationals or companies of one Contracting Party who in any of the situations referred to in that paragraph suffer losses in the territory of the other Contracting Party resulting from:
>
> (a) requisitioning of their property by its forces of authorities, or
>
> (b) destruction of their property by its forces or authorities, which was not caused in combat action or was not required by the necessity of the situation,
>
> shall be accorded restitution or adequate compensation. Resulting payments shall be freely transferable.

[39] Similarly, the Tribunals in *Enron v Argentina* and *Sempra Energy v Argentina* concluded that Article IV(3) of the Argentina-US BIT could not "be read as a general escape clause from treaty obligations and thus does not result in excluding wrongfulness, liability and eventual compensation" (*Enron v Argentina*, Award of 22 May 2007, para.321; *Sempra Energy v Argentina*, Award of 28 September 2007, para.363).

IV. Additional Considerations

Legal basis of necessity

The emerging jurisprudence suggests that the question of compensation depends on the applicable law that serves as a basis for invoking the necessity defence. If it is successfully invoked under a treaty clause similar to Article XI of the Argentina-US BIT, the claim for compensation is likely to be rejected, even though this matter has not been fully settled. Under customary international law, however, compensation is not excluded. Questions relating to specific circumstances which require payment of compensation as well as the extent of such compensation still await clarification, and at this point only some limited thoughts may be offered.

Who is to bear the losses?

A review of the relevant awards shows that in the final analysis, the deliberations have centered on the question of who was to bear the negative economic consequences of the crisis and the measure(s) adopted by a State to rectify the emergency situation. To recall, the rationale, identified by the ILC for requiring compensation in cases of "necessity", is that it would be unfair to shift the burden of losses from a State pursuing its own essential interests on to an innocent third State. Not disputing this basic rationale, it appears, however, that the doctrine of an "innocent third State" cannot be applied automatically in cases concerning foreign investments. In these cases, investors of the "third State" concerned are not innocent by-standers, who happened to suffer damages as a matter of pure contingency.

When making a decision to invest in a particular country, investors are, or must be, aware of the risks of investing in the country, including the dangers of political or economic instability. The decision to invest in a less stable country is a conscious and carefully considered one, taken as a result of balancing the promise of higher returns (compared to more stable countries) and higher risks inherent in the investment. Therefore, it is appropriate to attribute at least part of the damage to the investment

risk, when this risk materializes during the state of necessity. These considerations should play a part in deliberations on distribution of the burden of loss incurred under relevant circumstances.

Modalities of sharing losses

The reviewed cases show that there is more than one modality of sharing the burden of losses. Even though the defence of necessity failed the test in *CMS*, *Enron* and *Sempra Energy* and survived in *LG&E*, in each of the awards, the tribunals took into account the circumstances of the economic crisis in calculating the damages. In *LG&E*, having accepted the necessity defence, the Tribunal exempted the State from paying compensation for the losses incurred during the period of the crisis. In *CMS*, *Enron* and *Sempra Energy* even though the respective tribunals did not exempt the Respondent from its liability during the period of the emergency, they did take into account the economic impact of the crisis when calculating the amount of compensation. All the tribunals thus sought to distribute, albeit to differing extents, the burden of losses between the host State and the foreign investors concerned.

It would be interesting to compare the numerical results achieved under each of the two modalities of accounting for the crisis circumstances (one used in *LG&E*, and the other in *CMS*, *Enron* and *Sempra Energy*) and to assess which of them is more beneficial to a particular disputing party. However, this is impossible to do with precision, mainly because the tribunals took different *basic* approaches to measuring compensation – the *CMS*, *Enron* and *Sempra Energy* tribunals looked at the difference in the value of claimants' shares with and without the breaches, while the *LG&E* Tribunal used, as a measure of compensation, dividends not received by the Claimants during the time of the breach. Potentially, however, the *LG&E* method would leave States better off, especially where the length of the recognized period of necessity (and thus the period of the exemption from liability) is considerable. In fact, under the *LG&E* approach, a State would be fully absolved from liability if the measures at issue are taken after the commencement of the period of necessity and revoked at the end of this period.

Impact of the nature of damage

The nature of the damage may also make a difference in choosing the appropriate approach. For example, if a measure taken during the period of necessity leads to an instant loss of the entire investment (like in case of an outright abolition of certain business activity), compensation (possibly partial, for example not based on future profits) may be appropriate in order to spread the loss between the foreign investor and the State in a balanced manner. On the other hand, if as a result of a continuing breach, the damage is being inflicted gradually and spread in time, some of it occurring during the period of necessity and some outside this period, like the situation in *LG&E*, then the balanced distribution of the burden of negative economic consequences can be achieved by awarding no compensation for the damage suffered during the period of necessity but by compensating for all other damage.

The question of interest

The function of interest is to compensate an aggrieved party for the inability to invest, and receive income on, the amount of compensation that has not been paid to it in time. It follows that, generally, interest should run from the moment compensation is due until the compensation is paid. In expropriation cases, interest starts running from the date of expropriation; in cases of treaty breaches, it starts running from the date of the breach. On this basis, even if one adopts the pro-investor approach that the obligation to pay compensation is not terminated but merely suspended during the period of necessity, interest should stop running for this period and resume once it is over.

Obviously, under the approach where no compensation is awarded for the losses suffered during the period of necessity, the question of interest does not arise. Lastly, in a scenario where damage is incurred gradually, starting before the period of necessity and continuing after this period is over (like the situation in *LG&E*), interest on the "before" damage should run throughout the period of necessity because as a matter of law, compensation for that damage was due at the time of the breach.[40]

[40] The *LG&E* Tribunal seems to have made a mistake having calculated interest on the *full* amount of compensation starting from 18 August 2000 (the date of the first measure, before the commencement of

V. Conclusions

Customary international law, as reflected in the ILC Articles, does not offer a determinative solution to the question of compensation in cases where the defence of necessity is successfully invoked, leaving a large degree of flexibility and discretion to tribunals that will have to continue struggling with the uncertainty of the law. The case law available to date, scarce as it is, suggests that one may logically substantiate divergent approaches, from full compensation to no compensation for relevant losses. There is a general underlying objective to distribute equitably between the disputing parties the burden of the losses incurred during emergency situations. The case law also demonstrates that a country's circumstances may be taken into account to reduce compensation even where the necessity defence is rejected.

The necessity-type provisions of investment treaties, if interpreted as stand-alone and not requiring subsidiary application of customary international law, are likely to result in no compensation for the damages suffered during the recognized period of necessity. The contrary interpretation would mean that compensation should be determined under the rules of customary law. In light of the *CMS* Annulment Decision and given the uncertainty of customary law on the matter, the former interpretation will probably prevail.

Overall, in the absence of sufficient clarity of the law, arbitrators will inevitably base their decisions on what they see as equitable and reasonable in the circumstances of a particular case. On the one hand, this increases chances that the outcomes of disputes will be balanced but, on the other, makes these outcomes rather difficult to predict, prompting States to further clarify their respective obligations in investment treaties.

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the state of necessity). This approach appears to be over-compensating because in a no-breach scenario, the dividends would be received by the Claimants periodically, once in a year, rather than at once on 18 August 2000. (See *LG&E v Argentina*, Award of 25 July 2007, paras.104, 108).