

Comfort Letters and the Essential Security Exception in an Age of Instability: *Pacta Sunt Servanda* in a World of Strategic Rivalry and Crisis

Abstract

In the Chinese corporate context, offshore debt is often accompanied by a statement or assurance provided to a creditor relating to the debtor commonly referred to as a keep-well agreement or comfort letter. Such statements do not contain any express contractual promises nor do they generally allude or reference any specific details such as an amount of debt or a payments schedule. However, such statements may ostensibly evince an intent to provide liquidity to the debtor or to maintain the debtor's solvency. The statement-issuer thus provides "comfort" to the creditor serving as an inducement to provide the capital. Such statements are generally provided by a state-linked onshore parent to an offshore subsidiary memorializing the parent's intent to prevent the insolvency of the offshore subsidiary seeking to borrow capital. If the debtor cannot repay debt, creditors will endeavor to obtain payment from the state-linked letter issuer. In general, the enforceability of comfort letters is a legal enigma and national courts in various jurisdictions have viewed comfort letters in different ways. However, this article will not focus on national courts but rather on a hypothetical context of foreign investors failing to obtain relief in domestic courts and subsequently filing a claim in arbitration based upon an investment treaty seeking the sovereign-linked entity issuing the comfort letter to honor the agreement and re-pay the investors. Comfort letters issued by sovereigns or state-linked businesses present an intriguing legal issue. What is the impact of a sovereign (or state-linked entity) invoking the essential security exception of an investment treaty to override the letter? An economic crisis or national emergency might be claimed by the sovereign as constituting a threat justifying invoking the essential interest that would serve to override any investment agreement and nullify paying the investors' claims triggering the conflict between fulfilling contractual obligations versus defending the national bastion – this directly implicating *pacta sunt servanda*. As our world faces transformative changes including tectonic advances in emergent technology and the developing great power rivalry, notions of security need to be expansive and might encompass emergencies linked to economic, health and social stability. However, the slope is slippery. Re-conceptualizing the security exception is vital but an unfettered expansion risks undermining *pacta sunt servanda* and ultimately global governance, law, and markets.

The so-called keepwell provisions are supposed to protect a bondholder in case the mainland company runs into financial trouble. Nearly all of China Huarong's \$22 billion in dollar bonds have them. The problem is the clause essentially amounts to a "gentlemen's agreement," and is only starting to be tested in court.¹

Are key state-owned enterprises like Huarong still too big to fail, as global finance has long assumed – or will these companies be allowed to stumble, just like anyone else? The answers will have huge implications for China and markets across Asia. Should Huarong fail to pay back its debts in full, the development would cast doubt over a core tenet of Chinese investment: the assumed government backing for important state-owned enterprises, or SOEs.²

[A]lthough comfort letters in general do not give rise to legally binding obligations, courts will enforce them on a contract or promissory estoppel theory depending on the specific circumstances.³

I Introduction

Comfort letters or keep-well agreements provide written assurances or "comfort" to a creditor relating to the debt's ultimate re-payment.⁴ Comfort letters do not contain any express contractual promises of payment nor do they generally reference any specific debt details such as an amount or a payment schedule. Instead, comfort letters generally merely consist of a nebulously worded intent (or at best a potential commitment) to ensure sufficient liquidity to the debtor and/or to maintain the debtor's solvency.⁵ The purpose of these enigmatic "gentleman's agreements" is to induce lenders to provide capital but evading any explicit commitments to guarantee payment.⁶ Thus, comfort letters are dual-functional from the issuer's perspective, i.e., comfort letters encourage creditors to provide capital while simultaneously providing the letter issuer with plausible deniability as a means to avoid liability.

Unsurprisingly, amorphous statements are inherently problematic and open to various interpretations. In the event of debtor default, the letter provider may object to the demand for payment and argue the letter merely evinces (at most) an intent or willingness at *the time the*

¹ https://www.washingtonpost.com/business/what-keepwell-means-in-case-of-china-bond-defaults/2021/04/14/775341a0-9d64-11eb-b2f5-7d2f0182750d_story.html April 15, 2021

² Bloomberg News, <https://finance.yahoo.com/news/china-very-bad-bank-inside-032159830.html> April 15, 2021

³ *Lasalle Bank National Association v Citicorp Real Estate Inc.*, (2003 US Dist LEXIS 12043 (SDNY July 18, 2003) at 8.

⁴ This article will use the term comfort letters.

⁵ China Record \$30B Bond Defaults Seen Rising This Year, <https://www.bloomberg.com/news/articles/2021-01-11/china-s-record-30-billion-bond-defaults-seen-rising-this-year> Jan 12, 2021 ("The keepwell provision often involves a Chinese company's pledge to keep an offshore subsidiary that is issuing the bonds solvent -- but without any guarantee of payment to the bondholders.")

⁶ Creditors might in fact rely upon the letter in deciding to lend the capital; rating agencies might give a higher rating. Furthermore, if the letter issuer is a state-linked business, and thus presumably ultimately backed by a sovereign, rating agencies and capital markets might price the debt favorably with the tacit understanding a bailout would be forthcoming.

letter was issued to maintain the debtor's liquidity or solvency.⁷ Thus, the practical "real-life" problem of comfort letters is manifestly clear; upon a debtor's inability to pay, investors will demand payment from the issuer based on assurances to ensure the debtor's liquidity and/or solvency. However, given the undeniable fact that there is no explicit guarantee or express obligation of debt repayment, the letter issuer will claim the investor was well-aware of market risk and thus fully bears that loss.⁸

In the Chinese corporate debt context, such comfort statements are generally provided by an onshore parent to an offshore subsidiary memorializing the parent's intent to prevent the insolvency of the offshore subsidiary seeking to borrow capital. Indeed, a large amount of Chinese offshore debt is accompanied by a statement or assurance provided to a creditor relating to the debtor.⁹

It's a type of credit protection mainly seen in China's \$885 billion market for dollar bonds (those sold outside mainland China, denominated in U.S. dollars). The keepwell provision often involves a Chinese company's pledge to keep an offshore subsidiary that is issuing the bonds solvent -- *but without any guarantee of payment to the bondholders*. (Actual guarantees require regulatory approval but keepwells don't.)¹⁰

Concerns over Chinese corporate debt including state-linked corporate debt are rising. In 2020, Chinese state-linked entities defaulted on almost 80 billion Yuan debt - the majority of Chinese corporate defaults - implicating the "implicit state-backing" investors rely upon.¹¹ In good economic times, paying corporate debt is generally not a problem and investors do not pay much attention to comfort letters. However, when debt is not repaid, investors and their counsel examine all potential recovery sources – including any potential avenues of recovery based upon

⁷ Moreover, presumably, *if new circumstances warrant*, the issuer is no longer bound by any intent - presuming any initially existed.

⁸ Administrator for China's PUDG rejects keepwell deed for \$300 mln bond
<https://www.reuters.com/article/china-bond-keepwell-idUKL4N2FP01J> Aug 23, 2020

⁹ https://www.washingtonpost.com/business/what-keepwell-means-in-case-of-china-bond-defaults/2021/04/14/775341a0-9d64-11eb-b2f5-7d2f0182750d_story.html April 15, 2021 ("About \$119 billion of Chinese offshore bonds outstanding, or about 13% of the total, have the keepwell structure.")

¹⁰ https://www.washingtonpost.com/business/what-keepwell-means-in-case-of-china-bond-defaults/2021/04/14/775341a0-9d64-11eb-b2f5-7d2f0182750d_story.html April 15, 2021 (emphasis added).

¹¹ Tom Hancock, Huarong's Fate May rest With Xi Confidant Who Loathes Bailouts
<https://www.bloomberg.com/news/articles/2021-05-05/huarong-s-fate-may-rest-with-xi-confidant-who-loathes-bailouts> ("Signs of a shake-up came with a wave of defaults by state-linked companies last year. In 2020, SOEs reneged on a record 79.5 billion yuan in local bonds, making up more than half of defaults by Chinese corporations."); Bloomberg News, <https://finance.yahoo.com/news/china-very-bad-bank-inside-032159830.html> April 15, 2021 ("core tenet of Chinese investment: the assumed government backing for important state-owned enterprises.")

comfort letters. As global debt has increased exponentially, and the inevitable liquidity problems eventually surface, debt-holders will increasingly look to the comfort letter issuer to honor the pledge - vague as it might be.¹²

Litigation and arbitration is a likely outcome of this incipient problem.¹³ Indeed, the natural tendency to disclaim responsibility in the absence of an express obligation is exemplified by the administrator of Peking University Founder Group's ("PUFG") restructuring who rejected creditors' demands to pay claims based on comfort letters informing "a bondholder meeting that it doesn't believe it's responsible for honoring repayment" based upon such letters.¹⁴ PUFG is a Chinese state-linked entity that became embroiled in over-indebtedness and defaulted¹⁵ raising concerns over a potentially larger under-recognized problem.¹⁶ In contrast to the administrator disclaiming responsibility on behalf of debt issued by PUFG's offshore subsidiary upon which PUFG issued comfort letters, the PUFG administrator did in fact accept responsibility to re-pay debt which was expressly guaranteed by PUFG.¹⁷ [Check for updates]

The recent (and ongoing) litigation with respect to CEFC also serves to highlight the likelihood the issue will become increasingly important in coming years.¹⁸ CEFC issued comfort letters in support of a subsidiary's debt and the subsidiary defaulted. Creditors filed claims in Hong Kong (the locus of dispute resolution for the letters) against CEFC for failing to ensure the subsidiary's

¹² https://www.washingtonpost.com/business/what-keepwell-means-in-case-of-china-bond-defaults/2021/04/14/775341a0-9d64-11eb-b2f5-7d2f0182750d_story.html April 15, 2021 ("A potential restructuring at one of China's largest state-run asset managers of distressed debt -- China Huarong Asset Management Co. -- is stoking fresh concern about the labyrinthine structures that the nation's borrowers use to issue and guarantee offshore debt.")

¹³ https://www.washingtonpost.com/business/what-keepwell-means-in-case-of-china-bond-defaults/2021/04/14/775341a0-9d64-11eb-b2f5-7d2f0182750d_story.html April 15, 2021 ("Nearly all of China Huarong's \$22 billion in dollar bonds have them. The problem is the clause essentially amounts to a "gentlemen's agreement," and is only starting to be tested in court.")

¹⁴ <https://www.bloomberg.com/news/articles/2021-01-11/china-s-record-30-billion-bond-defaults-seen-rising-this-year> (Jan 12, 2021)

¹⁵ Edward White, <https://www.ft.com/content/8a30b7b8-864d-4478-a130-aeabd51863da> ("[PUFG], it is the largest defaulter on dollar-denominated debt in China in nearly two decades... It has also defaulted on Rmb36.5bn (\$5.6bn) of onshore bonds.")

¹⁶ Edward White and Thomas Hale, Global investors seek freeze, <https://www.ft.com/content/21d70ba3-f3c7-4f2a-b311-c5850d0d1af6> March 21, 2021 ("Tsinghua Unigroup, a national chip champion backed by China's most prestigious engineering school, in November defaulted on a domestically issued bond, triggering concerns over cross-defaults of offshore notes worth about \$2.4bn.")

¹⁷ Administrator for China's PUFG rejects keepwell deed for \$300 mln bond <https://www.reuters.com/article/china-bond-keepwell-idUKL4N2FP01J> Aug 23, 2020

¹⁸ Yujing Liu, https://www.scmp.com/business/companies/article/3040438/missed-bond-payment-chinas-state-owned-pekings-university-founder?utm_source=Yahoo&utm_medium=partner&utm_content=3113062&utm_campaign=contentexchange Dec 3, 2019 (a Shanghai court ruling involving the enforcement of Chinese offshore bonds containing a keep-well clause).

liquidity. Evidently CEFC did not defend and the court entered a default judgement which CEFC never paid. Creditors filed an enforcement suit in the Shanghai Financial Court for recognition of the HK default judgement which the court granted.¹⁹ While the Shanghai Financial Court ruling did not directly opine on the enforceability of comfort letters, the decision to enforce the HK default judgement is considered “positive for creditors” to the extent the HK ruling was held enforceable.²⁰

Further illustrative is the unfolding drama at Huarong Asset Management Co. (“Huarong”) whose CEO was executed for corruption and enjoying the company of numerous girlfriends.²¹ Huarong is a state-linked²² publicly traded corporation²³ created to provide an efficient solution to the “old” corruption and inefficiencies that plagued Chinese SOEs in the 1990s. Huarong accepted the bad debt of troubled SOEs and ostensibly managed the SOEs better enabling both the SOEs and Huarong to achieve significant profit. Yet, evidently, Huarong has immense liquidity problems of its own arising from massive debt issued to expand its business far beyond its core mission. In April 2021 Huarong bonds plunged to roughly half their value on concerns that Huarong was in serious financial trouble.²⁴

¹⁹ <https://mp.weixin.qq.com/s/vzsaoPIZcpQ8ql2jfVEQw> (ruling discussing the relationship between the Arrangement on Reciprocal Recognition and Enforcement of Judgments between the PRC and Hong Kong. Defendant letter issuer CEFC claimed the Hong Kong default judgement failed to comport the PRC’s social and public interest – which is a legitimate basis for declining recognition and enforcement under the Arrangement. However, the Shanghai Financial Court rejected this argument holding the letter was not governed by PRC law and held that it would recognize the Hong Kong default judgment under the Arrangement.)

²⁰ Edward White, Foreign investors face critical legal test for \$82bn in China bonds

<https://www.ft.com/content/8a30b7b8-864d-4478-a130-aeabd51863da> April 8, 2021 (“But the process is further complicated by questions over what role the Chinese Communist party may be playing behind the scenes. There is a lack of clarity over what impact this might have on foreign bondholders.”)

²¹ Dong Jing, Wu Hongyuran, and Charlotte Yang Exclusive: Fallen Chief of Bad-Asset Manager Had

Tons of Cash — Literally,
<https://www.caixinglobal.com/2018-10-17/fallen-chief-of-bad-asset-manager-had-tons-of-cash-literally-101335639.html> Oct 17, 2018 (former Huarong CEO had over 100 mistresses).

²² Approximately 60 percent of Huarong’s shares are owned by cite

²³ Huarong shares trade on the HKSE after a 2015 IPO. See cite

²⁴ Bloomberg News, <https://finance.yahoo.com/news/china-very-bad-bank-inside-032159830.html> April 15, 2021 (“Not since the Asian financial crisis of the late 1990s has the issue weighed so heavily. Huarong bonds -- among the most widely held SOE debt worldwide -- recently fell to a record low of about 52 cents on the dollar. That’s not the pennies on a dollar normally associated with deeply troubled companies elsewhere, but it’s practically unheard of for an SOE.”)

A large segment of Huarong’s subsidiaries’ debt was issued with a comfort letter ostensibly obligating Huarong to “honor” its subsidiaries’ debts. Indeed, the belief that Huarong’s subsidiaries’ debt might ultimately be backed by the state may certainly have induced investors to acquire the debt.

Should Huarong fail to pay back its debts in full, the development would cast doubt over a core tenet of Chinese investment: the assumed government backing for important state-owned enterprises, or SOEs.²⁵

This paper focuses on a hypothetical scenario of foreign investors pursuing ultimately unsuccessful claims based on comfort letters in either local Chinese or other courts,²⁶ and subsequently filing an arbitration claim pursuant to an investment treaty seeking the state-linked entity to honor the comfort letter and re-pay the investors.²⁷ Foreign investors will at times need to resort to an applicable investment treaty for several potential reasons.²⁸ Presuming *arguendo* that a direct claim could be made under Chinese law to domestic Chinese courts, the variety of language and the fact that the SPC has ruled that comfort letters which do not contain express guarantees are not automatically enforceable likely means at least some Chinese rulings will probably reject investor claims.²⁹ Alternatively, if investors file a claim in a foreign court not only would investors need to obtain a favorable ruling, but enforcement within China might be difficult. Although the Shanghai Financial Court enforced the CEFC default judgement, it is far from certain that other defendants would fail to defend and perhaps might even obtain a favorable verdict. Moreover, in response to the filing of a claim in Chinese courts, the court could simply be forced by MOFCOM pursuant to the Blocking Statute which is designed to defend China’s national interests and might be invoked.³⁰ If investors file claims outside of China, even if the judgement is favorable, Chinese courts may simply refuse to enforce any judgement based upon the new Blocking Statute and MOFCOM’s order, therefore thwarting enforcement as defending core national interests and security could trump the foreign judgement.³¹ Doing so might trigger a potential treaty-based arbitration claim whereby investors

²⁵ Bloomberg News, <https://finance.yahoo.com/news/china-very-bad-bank-inside-032159830.html> April 15, 2021

²⁶ Investors might indeed have success but enforcement in a Chinese court might be blocked based on defending China’s national interests and security. See Blocking Statute *infra* note 30.

²⁷ Alternatively, investors might sue the sovereign itself arguing the state-linked entity is merely a conduit for the sovereign which controls the corporation.

²⁸ Given that China has an extensive network of investment agreements where arbitration is the dispute resolution mechanism, this potential avenue will be examined by counsel for creditors. See <https://investmentpolicy.unctad.org/international-investment-agreements/countries/42/china>

²⁹ Verify and ADD SPC ruling

³⁰ <http://www.mofcom.gov.cn/article/b/c/202101/20210103029710.shtml> (Chinese); <http://english.mofcom.gov.cn/article/policyrelease/questions/202101/20210103029708.shtml> (English). Evidently a Chinese entity adversely effected by an overseas sanction – which might encompass a legal judgement – could request China’s MOFCOM to order enforcement blocked. (Add here FRAND litigation examples).

³¹ The intensification of the hegemonic rivalry may have not only an impact on notions of national security but implicate jurisdiction and injunctions.

allege Chinese governmental action damaged the foreign investor's economic interests thereby violating the investment guarantees in the treaty. In response to such claims, China could argue that doing so was required to defend her essential security interests and defeat the claim.

In general, the interplay between comfort letters and essential security and the inherent conflict between *pacta sunt servanda* and defending national interests may be an increasingly important business and legal issue going forward. Notions of security are expanding as it is increasingly recognized that emergencies can indeed severely impact essential security potentially encompassing health and social stability; but the slope is slippery. As threats to a nation's security change, the understanding of essential security will need to be re-conceptualized. To what extent are governments (or state-linked entities) obligated to guarantee payment when the sovereign claims a crisis or emergency constitutes an essential security interest overriding the letter? Can an economic crisis or other emergency³² constitute a threat to an essential interest that would nullify a comfort letter? Can a national "crisis" or "emergency" obviate *pacta sunt servanda*?

The specific context of Chinese corporate debt serves as an excellent vehicle to examine the issue for several reasons: a staggering amount of state-linked debt (and state-linked letter issuers); an apparent incipient risk of massive defaults; and the potential implication of the essential security exception in investment treaties if creditors resort to investment treaties.³³

Massive SOE Debt and Increasing Risks of Default

The issue of comfort letters will likely intensify in the future as Chinese corporate offshore debt is often issued with accompanying "enhancements" such as comfort letters which induce creditors to lend and might also serve to lower interest rates lenders are willing to accept. Chinese offshore debt is also significant³⁴ and in recent years debtors have increasingly turned to offshore financing. A staggering amount of debt "[a]bout \$119 billion of Chinese offshore bonds outstanding, or about 13% of the total, have the keepwell structure."³⁵

Globally, low interest rate policies have driven many investors hungry for yield. Such demand increases the willingness of lenders and investors to provide capital driving demand for riskier and lower tiers of debt as creditors are seeking higher yields. Risks are often overlooked or

³² Interestingly, despite previous events such as SARS and Ebola, research has not discovered case law on effects of a health crisis operation on comfort letters.

³³ The scope of legal issues is extensive and the focus is on whether arbitrators should accept the essential security exception as legitimate to override an investment treaty and the inherent *pacta sunt servanda* embedded within the treaty. It is well-beyond the scope of the paper to delve extensively into whether the arbitrators – if the exception is rejected - should find the comfort letter enforceable based on promissory estoppel/implied contract but nevertheless some suggestions are enumerated prior to the conclusion.

³⁴ Edward White and Thomas Hale, Global investors seek freeze, <https://www.ft.com/content/21d70ba3-f3c7-4f2a-b311-c5850d0d1af6> ("Chinese non-financial companies owe \$575bn in offshore dollar-denominated debt, with \$72bn maturing this year [2021].") Compare Bloomberg

³⁵ https://www.washingtonpost.com/business/what-keepwell-means-in-case-of-china-bond-defaults/2021/04/15/c53780d2-9dbb-11eb-b2f5-7d2f0182750d_story.html

glossed over in this environment, and a consensus has emerged that low rates and the encouraging of excessive risk-taking creates investment bubbles.³⁶ Of course with reward there is added risk particularly in times of crisis. Global economic turbulence, pandemics and other national crisis, might impinge a debtor's ability to re-pay and/or a comfort letter issuer to rescue the debtor.³⁷ Indeed, Chinese debt defaults both onshore³⁸ and offshore are already steadily increasing³⁹ and concerns are building that a wave of defaults may occur.⁴⁰

Moreover, a large percentage of the debt problems are from state-linked corporate debt implicating moral hazards and China's state-centric economic governance. This risk-taking or "moral hazards" may be magnified when the letter writer is a state-linked entity and/or the debtor is state-linked as presumably, the state will not allow a state-linked entity to default as its own future economic interests are endangered. This might also trigger a creditor to claim reliance on a government-linked letter issuer implicating good-faith as discussed below.

Expanding Notions of Essential Security and Pacta Sunt Servanda

Comfort letters issued by state-linked businesses present an overarching intriguing legal issue in international economic law. Investment treaties obligate nations to contractual undertakings which are dominant over domestic considerations. However, treaties contain escape valves where the sovereign can override a treaty obligation to defend for example essential security interests. The interplay between an investment treaty and the possibility of using an exception to override the agreement is intriguing and directly raises the *pacta sunt servanda* principle.⁴¹ The

³⁶ <https://www.imf.org/en/Publications/GFSR/Issues/2019/10/01/global-financial-stability-report-october-2019>

³⁷ See Morgan Davis, Its crunch time for Chinese SOE bonds, <https://www.globalcapital.com/article/b1rh29j3r7fwq5/its-crunch-time-for-chinese-soe-bonds>, April 20, 2021 (recent debt problems highlight the risks of acquiring Chinese state-owned corporate debt).

³⁸ <https://www.bloomberg.com/news/articles/2021-01-11/china-s-record-30-billion-bond-defaults-seen-rising-this-year> (Jan 12, 2021) ("Five state-linked companies defaulted for the first time in the onshore bond market, the most since 2016...")

³⁹ White FT <https://www.ft.com/content/8a30b7b8-864d-4478-a130-aeabd51863da> ("Some 39 Chinese companies both domestically and offshore defaulted on nearly \$30 billion of bonds in 2020, pushing the total value 14% above 2019's.")

⁴⁰ Tom Hancock, Huarong's Fate May rest With Xi Confidant Who Loathes Bailouts <https://www.bloomberg.com/news/articles/2021-05-05/huarong-s-fate-may-rest-with-xi-confidant-who-loathes-bailouts> ("Huarong has the equivalent of \$41.3 billion in bonds outstanding. A state bank recently stepped in to help it pay maturing debt, suggesting officials may be concerned about systemic risk.")

⁴¹ G. Von Glahn, *Law Among Nations: An Introduction to Public International Law* 498 (4th ed. 1981) ("One of the oldest principles in international law is one usually rendered as *pacta sunt servanda*: 'treaties must be observed.'")

principle is well-recognized and in fact China embraces this principle⁴² and has relied upon it in international law disputes with other nations.⁴³

In our context, the question is whether sovereign or the state-linked entity issuing the letter can invoke the “essential” or “national” security exception to override the letter. Skyrocketing sovereign debt, defaults and the moral hazards of bailing out state-backed businesses may occur in the context of a severe economic crisis, health crisis, or a catastrophic natural disaster. Moreover, notions of security must also grapple with emergent technology which may pose serious security threats in the longer-term but are relatively innocuous when the sovereign seeks to invoke the security exception. Furthermore, the political-economic dimension is potentially significant; the transformatory China-U.S. rivalry implicates essential security interests. What role does *pacta sunt servanda* and the overarching importance of performing treaty compliance in good-faith?⁴⁴

II Comfort Letters: A (Very) Brief Primer

Comfort letters are statements drafted by a third party intended to incentivize a transaction between two other parties one of which is related to the letter issuer and reflect the unwillingness to enter into a formal contract containing explicit guarantees.⁴⁵ While comfort letters can arise in a wide variety of circumstances,⁴⁶ our context is a third-party usually a parent entity issuing a letter relating to a subsidiary’s debt.⁴⁷ The overriding characteristic of comfort letters is that they constitute “nebulous commitments of support” lacking concrete obligations of debt repayment. This is unsurprising given that a comfort letter is essentially a replacement for the refusal of the letter provider to formally guarantee payment *while simultaneously inducing a transaction*.⁴⁸

⁴² Articles 3 to 8 Contract Law of the PRC. – cite (ask Lutz).

⁴³ <http://id.china-embassy.org/eng/jrzg/t1327179.htm> (China critiquing the Philippines for failing to comply with *pacta sunt servanda* since there was already an agreement related to a territorial dispute. “By unilaterally initiating the arbitration, the Philippines has negated its solemn commitment to its neighbors and the international community, and breached one of the core principles in international relations - *Pacta sunt servanda* (“agreements must be kept”), thus jeopardizing its own international credibility. By contrast, China’s position of not accepting or participating in the arbitration demonstrates that it is true to its words.”)

⁴⁴ H. Kelsen, *Principles of International Law* 456 (2d ed. 1962) (principle of *pacta sunt servanda* demands good-faith contractual compliance).

⁴⁵ Larry DiMatteo, *The CISG and the Presumption of Enforceability: Unintended Contractual Liability in International Business Dealings*, 22 *Yale J. Int’l. L.* 111, 114 (1997).

⁴⁶ Comfort letters have various contexts. See e.g., *Kleinwort Benson Ltd v Malaysian Mining Corp Berhad* [1989] 1 *WLR* 379, parent-subsidiary context); *Lasalle Bank National Association v Citicorp Real Estate Inc* US Dist LEXIS 15069 (2003) (franchisor and franchisee).

⁴⁷ See Larry DiMatteo and Rene Sacasas, *Credit and Value Comfort Instruments: Crossing the Line from Assurance to Legally Significant Reliance and Toward a Theory of Enforceability*, 47 *Baylor Law Review* 357 (1994).

⁴⁸ Bernstein and Jakoll *The Gentleman’s Agreement in Legal Theory and in Modern Practice: United States* (1998) 46 *American Journal of Comparative Law* 87 at 99 (“Comfort letters are often drafted by a parent company and are aimed at encouraging a lending institution to issue credit to a subsidiary.”)

The drafter of the instrument wants to avoid incurring liability on the parent company's part for the non-performance of the potential debtor, the subsidiary. Yet, at the same time, the parent wishes to encourage the potential creditor, the financial institution, to enter into a legally binding transaction. In other words, a comfort letter of this type is aimed at being something more than a letter of introduction, but something less than a guaranty or suretyship commitment. Some commentators have found that such instruments "contain language that could induce reliance while they attempt to disclaim any liability as a guaranty," and this has led them to describe such comfort letters as "inconsistent" and "internally repugnant."⁴⁹

If default occurs the letter issuer will likely disclaim any purported obligation to pay based upon the absence of a contractual guarantee.⁵⁰ In response, the creditor will initiate legal proceedings to “enforce the letter” against the letter issuer and demand payment.⁵¹ Unsurprisingly, in the absence of a specific promise or guarantee, and given the wide range of potential language employed, courts in various jurisdictions have not uniformly ruled on whether such understandings are enforceable against the letter provider.

In terms of a court’s analysis, the initial step must be to examining the specific wording of the comfort letter. This might conclusively lead to a finding that there is in fact a formal contract and a guarantee. For example, if the parent promised the creditor that the subsidiary would fulfill its obligations under the loan agreement, then the parent may be liable for the payment of damages arising out of the subsidiary’s non-compliance. However, generally speaking, comfort letters contain ambiguous wording that relate to “maintaining solvency” or “liquidity” or an even more illusory statement alluding to a parent corporation using “best efforts” (or merely “efforts”) to maintain the solvency or liquidity of the borrower.⁵² Such language in a comfort letter can render establishing express obligations a difficult perhaps even insurmountable task.

Courts tasked with ascertaining the contours of the letter and deciding whether a third-party shoulders responsibility for payment will also examine the language used to extract the intent of the parties. In a comfort letter, discerning the parties’ intent might be extraordinarily difficult; in addition to amorphous language, motivations might be nefarious such as inducing a creditor with

⁴⁹ Id.

⁵⁰ Letter issuers will defend claiming there was no express guarantee and was in effect a “gentlemen’s agreement” with no obligation. *Goding v Frazer* (a deal “in which each side hopes the other will act like a gentleman and neither intends so to act if it is against his material interests”) [1966] 3 All ER 234 at 239

⁵¹ Creditors will file suit and claim the letter issuer must make the plaintiffs whole. See *Toronto Dominion Bank v Leigh Instruments Ltd (Trustee of)* (1998) 40 BLR (2d) 1, affd 178 DLR (4th) 634, leave to appeal to the Supreme Court of Canada refused [2000] 1SCR xxi; *Bouygues SA v Shanghai Links Executive Community Ltd* [2000] 2 HKLRD 479; *Hong Kong and Shanghai Banking Corporation Ltd v Jurong Engineering Ltd* [2000] 2 SLR 54.

⁵² Alternatively, even without contractual liability there may be liability to repay based upon promissory estoppel or conduct improperly inducing the transaction as discussed below. This step requires looking at the transaction from a good-faith perspective and this has been a topic of intense academic discussion. Add here cites to civil/common law views.

foreknowledge of future debt problems.⁵³ Of course, the motivation behind using a comfort letter is not inherently or necessarily improper; legitimate reasons for using a comfort letter exist⁵⁴ and may be regulatory⁵⁵ although this may have various conflicting interests. Thus, the motivation(s) for using a comfort letter may also include both “good” and “bad” reasons.

Moreover, language is not the sole controlling factor in ascertaining intent and ultimate resolution of the enforceability of a comfort letter.

The language used in an instrument alone will not determine whether it is binding in law or "in honor only," rather the manifested intent of the parties and doctrines such as promissory estoppel need to be considered as well.⁵⁶

Courts also enforce statements that are not formally contracts based upon a more holistic view of the transaction. Reliance on statements and intent is crucial since reliance on the statement if reasonable, might implicate notions of tortious conduct and raise a question of enforceability through a non-strictly contractual basis such as promissory estoppel.⁵⁷

Although the line between contract and tort may not have broken down, courts are probably more inclined now to consider the entire course of interactions between the parties in determining the issue of contractual liability in the absence of a binding promise....In addition to considering the context of the parties' dealings and reliance theory as opposed to bargain theory, courts are also more likely to supply material terms

⁵³ While knowing in advance the debtor would be unable to re-pay clearly raises the issue of fraud, another illustration of misconduct is the possibility of collusion between debtor and letter issuer to loot the capital out of the borrower's control to an unreachable location at the parent or some other third-party.

⁵⁴ Letter issuers might not be empowered to guarantee due to governmental restrictions or financial encumbrances. Other potential reasons include the desire to avoid contingent liabilities in financial disclosures or tax implications. corporate parent looking to avoid adding the debt to its books or potentially adverse impacts on the parent's ability to borrow confining debt to a subsidiary may simply constitute strategic business decision to avoid formally guarantee debt repayment on behalf of other entities Doing so could also be a form of inducing the debtor to return to the creditor in the future as the creditor was willing to lend without a contractual guarantee from the letter issuer or another third-party thus fostering a potential long-term business relationship

⁵⁵ https://www.washingtonpost.com/business/what-keepwell-means-in-case-of-china-bond-defaults/2021/04/14/775341a0-9d64-11eb-b2f5-7d2f0182750d_story.html April 15, 2021 (“Actual guarantees require regulatory approval but keepwells don't.”).

⁵⁶ Bernstein and Jakoll *The Gentleman's Agreement in Legal Theory and in Modern Practice: United States* (1998) 46 *American Journal of Comparative Law* 87 at 101.

⁵⁷ While beyond the scope of this paper, vigorous scholarly discussions of promissory estoppel and theories underpinning courts' invocation of estoppel to enforce statements range from tort to equity and various hybrid conceptualizations. See, e.g., Andrew Tettenborn, *Contract Law* (Cambridge 2015) at pages 140-150 (discussing estoppel as an equitable principle).

omitted in an otherwise enforceable agreement, and are more likely to focus their attention on the presence or absence of good faith and the fairness of an exchange.⁵⁸

The question of promissory estoppel is discussed following the sub-section on good-faith but the two are interrelated. Good faith in the context of comfort letters runs in both directions; the letter issuer's motivations and the creditor's alleged reliance on the letter. Whether or not the overall circumstances and historical relationship justifies satisfying the "spirit of the letter" is not the same as expecting the letter receiver to believe the letter reflects a mere moral as opposed to a formal legal obligation. Yet this is the dilemma, did the investor truly rely upon the letter or is it a rationale – perhaps even with foreknowledge that the debt might not be repaid - to engage in a hunt for yield? Buying the debt of financially troubled corporations may occur in a situation whereby investors knowingly assume the risk but acquire the higher-yielding debt hoping for a significant return. And if the letter issuer is a state or state-linked entity does that transform the comfort letter into a more concertized and justifiable reliance? A related question is the exemplar of defaulted sovereign debt acquired by sophisticated investors at bargain prices who engage in legal strategies to obtain recoveries – a calculated market bet with complete understanding that there are no guarantees in the market but with the understanding that nations need access to capital markets and might this be required to resolve the litigation due to potentially reputational harm.⁵⁹

Good-Faith

Good-faith is a crucial factor in interpreting contracts and statements such as comfort letters since often not all terms are clearly evinced in the wording of an agreement.⁶⁰ For our purposes, there are several important reasons for utilizing good faith. One, comfort letters are negotiated and drafted as assurances provided to supplement the formal contract implicating notions of good-faith.⁶¹ Indeed, issues of good faith are particularly pertinent to comfort letters since the language used is often vague and areas of doubt exist with regard to the parties' intentions.⁶² Good-faith is a two-way street; good faith with respect to the issuer's statements of "comfort" and good-faith in terms of any reliance on the "comfort". Two, good-faith may be especially relevant when a state-linked entity provides the letter as governmental promises might be

⁵⁸ Bernstein and Jakoll, *The Gentleman's Agreement in Legal Theory and in Modern Practice: United States* (1998) 46 *American Journal of Comparative Law* at 94-95.

⁵⁹ <https://www.nytimes.com/2016/04/25/business/dealbook/how-argentina-settled-a-billion-dollar-debt-dispute-with-hedge-funds.html>

⁶⁰ See Arthur Rosett, *Critical Reflections on the United Nations Convention on Contracts for the International Sale of Goods*, 45 *Ohio St. L.J.* 265, 287 (1984) ("No written contract is ever complete; even the most carefully drafted document rests on volumes of assumptions that cannot be explicitly expressed.")

⁶¹ See, e.g., IE Davidson, J Wohl & D Daniel *Comfort Letters under French, English and American Law* (1992) 3 *JBFLP* 3, 6 (Good faith considerations important in enforcement of obligations and since comfort letters can be interpreted as a guarantee, good-faith is a factor).

⁶² See eg EA Farnsworth *Good Faith in Contract Performance* in J Beatson & D Friedmann (eds) *Good Faith and Fault in Contract Law* (Oxford: Clarendon Press, 1995) ch 6; WF Ebke & BM Steinhauer *The Doctrine of Good Faith in German Contract Law* in Beatson & Friedmann, chapter 7

understood as conveying a sense of more “muscle” and “solid” as the state is generally empowered to tax as well as have a reputation to protect. Three, good-faith is critical in the context of invoking any potential essential security exception in an investment treaty.⁶³ Four, good-faith is a critical core principle of *pacta sunt servanda*.

With respect to good-faith, there is no bright line test; the conceptualization and contours of good-faith are often unclear and based upon the perspectives of the parties’ history, self-interest and perceptions.⁶⁴

It is undisputed that good faith has a subjective component that requires a party at least to make an honest judgment. An honest judgment in one's own self-interest is sufficient to meet this subjective component.⁶⁵

But good faith is ultimately linked to honesty and fairness – a sense that justice is the overarching goal. To a degree, this is conveyed in the slogan “honor among thieves” that even criminals who will enthusiastically commit other crimes value honesty and disdain lies and will in fact refuse to lie to achieve their goals.⁶⁶

For example, if the parent issuing the letter took the money borrowed from the subsidiary and transferred the capital to the parent’s onshore operations, this might degrade the claim of good-faith. Foreknowledge – or foreseeability – of the subsidiary’s future liquidity issues would also imply a sense of bad faith. Yet the buyer’s knowledge may possibly also not be an innocent party; if the buyer is a sophisticated financial institution with an intension to offload the potentially toxic debt perhaps there is a lack of good-faith on both sides.⁶⁷

In the aftermath of the sub-prime crisis in the United States, a substantial amount of criticism was leveled at large financial institutions who had been actually aware (or should have been aware) of the poor quality of the investments.⁶⁸ The example of Timberwolf is illustrative. As the Senate Hearing testimony brought out, Goldman Sachs (“GS”) unloaded a large amount of Collateralized Debt Obligations known as the “Timberwolf deal” which internally it believed to be debt that would not be fully repaid.⁶⁹ GS responded that it did nothing wrong because it sold securities at the price the market priced the debt.⁷⁰ Senator Carl Levin cross-examined a GS

⁶³ See Chao Wang, Invocation of National Security Exceptions under GATT Article XXI: Jurisdiction to Review and Standard of Review, 18 Chinese JIL (2019), 710 (States are limited to good-faith invocation of the security exception).

⁶⁴ HK Licke Good Faith and Contractual Performance in PD Finn (ed) Essays on Contract (Sydney: Law Book Co, 1987) chapter 5, 160 (footnotes omitted). See also A Mugasha 'A Conceptual-Functional Approach to Multi-Bank Financing' (1995) 6 JBFLP 5, 23-24

⁶⁵ Farnsworth at 163

⁶⁶ See John Grisham, The Summons (2002), page 316 (Patton French, the King of Torts proclaims to Ray Atlee, “I don’t lie. I cheat and bribe, but I don’t lie.”)

⁶⁷ See supra the example of hedge fund investors knowingly assuming market risk to achieve stellar gains through buying distressed debt.

⁶⁸ <https://www.youtube.com/watch?v=whlzFWwVv98> (Senator Carl Levin examining Goldman Sachs over internal knowledge that the securities were in effect “suckers bets” that Goldman sold to clients).

⁶⁹ Id.

⁷⁰ Id.

witness asking how GS could sell investments to clients when it internally was aware that the investments would fall in value.⁷¹ GS was sued and settled at least one case where an investor claimed losses exceeding \$1B.⁷²

Good-faith is also important in the context of international law and the International Court of Justice has commented on the vital significance of good-faith in international law and fulfillment of treaty obligations.

One of the basic principles governing the creation and performance of legal obligations... is good faith. Trust and confidence are inherent in international cooperation, in particular in an age when this cooperation in many fields is becoming increasingly essential. Just as the very rule of *pacta sunt servanda* in the law of treaties is based on good faith, so also is the binding character of an international obligation. Thus interested States may take cognisance of unilateral declarations and place confidence in them, and are entitled to require that the obligation thus created be respected.⁷³

Thus, good faith and *pacta sunt servanda* are closely related and applying these inextricably-linked principles encompasses the interpretation of creditor reliance on the statements and promissory estoppel.⁷⁴

Estoppel Making Non-Guarantees Enforceable

Statements provided to a party that cause good-faith reliance may act to remove the technical strictures of a contract and ensconce the letter as an enforceable statement based on promissory estoppel.⁷⁵ The estoppel argument relies on a duty – “the promisor has a duty to prevent a promisee’s detrimental reliance.”⁷⁶ Thus, the enforcement of statements pursuant to estoppel is based on principles of tortious behavior or a mix of tort and contract.⁷⁷

⁷¹ Id.

⁷² Timberwolf <https://www.reuters.com/article/us-goldmansachs-lawsuit-idUSTRE79R4JE20111028> (it knew would default) case settled <https://www.bloomberg.com/news/articles/2016-06-14/goldman-sachs-agrees-to-end-1-billion-lawsuit-over-cdos>

⁷³ Nuclear Tests Case (Australia v France) (Merits) [1974] ICJ Rep 253 para 46.

⁷⁴ In addition, both principles are crucial in interpreting the essential security exception as discussed *infra*.

⁷⁵ For a comprehensive overview of developments in promissory estoppel see Charles L. Knapp, *Rescuing Reliance: The Perils of Promissory Estoppel*, 49 *Hastings L.J.* 1191 (1998) (tracing the development of estoppel in U.S. courts). Promissory estoppel is a principle of contract interpretation promoted relevant when the promisor would reasonably expect to induce reliance and if in fact relied upon with detrimental consequences, may be treated as an implied contract and an enforceable promise. See, e.g., *Drennan v Star Paving Co* 333 P 2d 757 (1958) (J. Traynor). The principle is inextricably connected to good-faith in the international context as well. See The preamble to the Vienna Convention on the Law of Treaties states that “the principles of free consent and of good faith and the *pacta sunt servanda* rule are universally recognized.”

⁷⁶ Eric Mills Holmes, *Restatement of Promissory Estoppel*, 32 *Willamette L. Rev.* 263, 515–16 (1996).

⁷⁷ See Eric Mills Holmes, *The Four Phases of Promissory Estoppel*, 20 *Seattle U. L. Rev.* 45 (1996) (noting that some scholars opine promissory estoppel is really a tort-based claim). The relationship

The whole thrust of the law today is to attempt to give proper effect to commercial transactions. It is for this reason that uncertainty, a concept so much loved by lawyers, has fallen into disfavour as a tool for striking down commercial bargains. If the statements are appropriately promissory in character, courts should enforce them when they are uttered in the course of business and there is no clear indication that they are not intended to be legally enforceable.⁷⁸

Thus, under promissory estoppel, the characterization is not important – it is the words and what they convey and whether there is in fact good-faith reliance on the assurance.

Estoppel might be particularly relevant in the context of disputes over state-linked entity issued comfort letters since such letters are bereft of express guarantees but presumably carry the authority of sovereign backing.⁷⁹

With its equitable underpinnings—good faith, conscience, honesty, and equity—promissory estoppel recognizes the promisee’s right to reasonably rely, arising from the reasonable expectations created and foreseeable by the promisor. The promisor’s statements and manifestations must objectively evidence a sufficient commitment or assurance on which a reasonable person foreseeably would rely.⁸⁰

It might be argued that reliance on a governmental promise carries more weight than a purely private promisor and there is an enhanced duty to preclude a detrimental reliance. But here good-faith also runs towards the investor. Courts generally understand that sophisticated parties are well-aware of the obligation to perform due diligence and the bar to demonstrate detrimental reliance on statements is higher as opposed to ordinary public investors.

Indeed, “as a matter of law, a sophisticated plaintiff cannot establish that it entered into an arm’s length transaction in justifiable reliance on alleged misrepresentations if that plaintiff failed to make use of the means of verification that were available to it, such as reviewing the files of the other parties.”⁸¹

between contracts and tort law – beyond the scope of this paper – is a fascinating topic. See Lutz-Christian Wolff, *The relationship between contract law and property law*, 19 *Common Law World Review* (2020), 40 (noting prior research about the relationship between torts and contracts).

⁷⁸ J Lipton, *Good Faith and Letters of Comfort*, 28 *University of Western Australia Law Review* 138 at 148-149 (1999) (comfort letters can be enforced based on notions of good faith and promissory estoppel)

⁷⁹ See *Lasalle Bank National Association v Citicorp Real Estate Inc.*, 2003 US Dist LEXIS 12043 (SDNY July 18, 2003) (“[A]lthough comfort letters in general do not give rise to legally binding obligations, courts will enforce them on a contract or promissory estoppel theory depending on the specific circumstances.”).

⁸⁰ Eric Mills Holmes, *Restatement of Promissory Estoppel*, 32 *Willamette L. Rev.* 263, 515–16 (1996).

⁸¹ See *Landesbank Baden–Württemberg v. Goldman, Sachs & Co.*, 821 F. Supp. 2d 616, 624 (S.D.N.Y. 2011).

Sampling of Judicial Perspectives

Predictably, judicial perspectives vary with respect to comfort letters. Courts diverge in view of the specific requirements existing under the applicable legal system, coupled with the inherent difficulty in determining the intent of the parties' with respect to statements with no explicit guarantees.⁸² While it is indisputable that comparing legal systems is challenging,⁸³ some examination of various viewpoints may prove instructive to our overall discussion.

Some courts find comfort letters create legal obligations despite no express obligation; other rulings hold that mere statements of intent such as keeping a subsidiary solvent are exactly that and no more – and containing no guarantee. In *Kleinwort*, the parent issued a comfort letter because it was not willing to guarantee the indebtedness of its wholly-owned subsidiary.⁸⁴ The lower court found in favor of enforcement finding that the “comfort letters came into existence as part and parcel of a commercial banking transaction, [and] the plaintiffs clearly acted in reliance.”⁸⁵ But the appeals court reversed because the language merely noted the present intent of the parent entity as opposed to anything further *and the refusal to provide an express guarantee underscored the lack of the intent to provide one.*⁸⁶

In a more recent example, the court refused to compel a parent to “honor” a comfort letter issued in support of its subsidiary. The lender argued that the comfort letter constituted an “unequivocal commitment” by the parent and an integral part of the loan. The parent countered that there was no wording of “guarantee” and a commitment is no substitute. The court agreed with the letter issuer finding the lack of an express guarantee indicated the letter was not a guarantee and the parent had no liability.⁸⁷ Under the reasoning of courts finding no enforceable agreement, if the

⁸² The issue of comfort letters is vexing. See T Vollans, “You Sitting Comfortably?” (1996) 17 Business Law Review 232; Thai, “Comfort Letters – A Fresh Look?” (2006) 17 Journal of Banking and Finance Law and Practice 15.

⁸³ See Lutz-Christian Wolff, ‘Comparing Chinese Law...But with Which Legal Systems?’ (2018) 6(2) *CJCL* 151–73 (“The choice of legal systems for comparative law purposes stands at the core of any comparative law methodology and must consequently be aligned with the goals of the comparative law project. In fact, the choice of suitable legal systems is crucial for attaining those goals and thus for the success of a comparative law project.”).

⁸⁴ See *Kleinwort Benson Ltd.* [1989], 1 W.K.L. REP. at 379.

⁸⁵ See *Kleinwort Benson Ltd.* [1988], 1 W.K.L. REP. at 799

⁸⁶ See *Kleinwort Benson Ltd.* [1989], 1 W.K.L. REP. at 393-94.

⁸⁷ Rohit Jain, *Zee vs Yes Bank: Letter of Comfort Not A Guarantee, Bombay High Court Says*, <https://www.bloomberquint.com/law-and-policy/zee-vs-yes-bank-letter-of-comfort-not-a-guarantee-bombay-high-court-says> Aug 19, 2020. See also *Lucent Technologies v. ICICI Bank*, <http://www.indiankanoon.org/doc/1461224/> (the language of letter of comforts tendered by Lucent Technologies were not creating any legal relations between the parties and hence, were not in form of any guarantee....[N]o manifest intention to make that letter enforceable as a guarantee as derived from the literal interpretation of the phrases used and therefore it was held to be unenforceable.); *United Breweries Ltd. v. Karnataka State Industrial Investment and Development Corporation* <https://www.casemine.com/judgement/in/56b4957d607dba348f01303e> (the value of such a letter is

creditor truly expects a guarantee which is not forthcoming, the creditor has the right not to enter into the transaction or alternatively bears the risk since no guarantee is in fact provided. In a very real sense, by accepting a non-guarantee comfort letter, the creditor is unreasonable in relying upon the letter as a guarantee.

An interesting case is *Lasalle Bank National Association v Citicorp Real Estate Inc.*⁸⁸ which noted the relative dearth of case law on comfort letters. The court stated that comfort letters were somewhat inherently at odds with themselves - comfort letters encouraged creditors to provide capital while simultaneously providing the letter issuer with means to avoid liability. According to the court however, even if no formal contractual express guarantees exist, the letter might constitute an enforceable implied contract and liability could ensue.⁸⁹ The court utilized an estoppel approach to determining whether the letter did in fact create an enforceable contract.

To resolve whether an implied contract existed under an estoppel theory, the court noted a list of factors for courts to weigh: the language used in the letter; the context in which the letter was provided; the parties' sophistication; prior business history and relationships; the "business understanding" of letters in the specific business area; did attorneys draft and edit the letter; did any party communicate unwritten representations; was creditor reliance reasonable under a promissory estoppel or detrimental reliance theory.⁹⁰

The court ruled that if the plaintiff could demonstrate reliance on the letter – and that such reliance was reasonable based upon the totality of the circumstances – the letter might be enforceable on grounds of promissory estoppel.⁹¹ After reviewing the factual background, the court rejected enforcement as requested by plaintiff holding that plaintiff's reliance on the letter was unreasonable; specifically, the plaintiff as a large global financial institution was sufficiently knowledgeable that the reference to the letter being a comfort letter indicated no express guarantee was intended.⁹² Thus, there was an absence of good-faith detrimental reliance. While the Lasalle court rejected the creditor's claims, the articulated list of factors is a useful method of determining whether an estoppel argument is valid in a particular claim.

merely recommendatory and not enforceable per se unless the obligations have been specifically undertaken by the issuer.)

⁸⁸ 2003 US Dist LEXIS 12043 (SDNY July 18, 2003)

⁸⁹ Bernstein and Jakoll *The Gentleman's Agreement in Legal Theory and in Modern Practice: United States* (1998) 46 *American Journal of Comparative Law* 87 at 100 ("The parent company, however, may find itself held liable as a guarantor when a court considers the letter in the context of the whole relationship among the three parties and finds it to be part of an implied contract.")

⁹⁰ 2003 US Dist LEXIS 12043 (SDNY July 18, 2003) at 25-26 citing Herbert Bernstein and Joachim Zekoll, "The gentleman's agreement in legal theory and modern practice" *The Gentleman's Agreement in Legal Theory and in Modern Practice: United States* (1998) 46 *American Journal of Comparative Law* 87 at 98-101.

⁹¹ Id at 25-26.

⁹² Id. at 25-26. Moreover, the letter was not submitted to the plaintiff as part of the loan package and the purpose of the letter was not even clear. See id.

III Comfort Letters in Times of Crisis

This Part will discuss the issue of *pacta sunt servanda* from the perspective of investors filing claims which are either unsuccessful or blocked and subsequently pursuing claims under an investment treaty to enforce the comfort letter.⁹³ In response to investors' claims, the sovereign might invoke the security exception in response to claims of treaty violation.

Preliminary comments

In recent decades, the overriding aim of international economic governance was to foster trade and investment through a proliferation of international economic agreements to promote world peace and prosperity. While international investment and trade agreements allow some exceptions, the goal was to confine derogations to a minimum and within a narrow set of exceptions.⁹⁴ For example, these agreements usually contain a national security or essential security exception⁹⁵ allowing sovereigns to defend their national interests and grounded in the international law principle of self-defense.⁹⁶ Since measures undertaken to restrict free trade and investment are inapposite to the contractual obligations, doing so is frowned upon and generally considered “a last resort”⁹⁷ and subject to satisfying the strictures of “necessity” i.e., the need to

⁹³ Several scenarios might result in investor claims. See *supra*.

⁹⁴ Exceptions to the mantra of vigorous trade were frowned upon. For example GATT Art XX allowed some exceptions for essential security but exception was not frequently invoked and not until the last couple of years has the exception been interpreted.

⁹⁵ Interpretations of the security exception in international economic agreements depend on specific contract language. See Lutz-Christian Wolff, *The relationship between contract law and property law*, 19 *Common Law World Review* (2020), 54 (“[A] clear terminological framework is needed to ensure a focused discussion and to facilitate the unambiguous analyses of any area of law.”). The Article proceeds with the understanding that national security and essential security are often undefined in agreements which simply refer to “national” or “essential security”. However, both terms are substantially interchangeable for purposes of conceptualizing the exception. See Thomas W. Walde, *Managing the Risk of Sanctions in the Global Oil & Gas Industry: Corporate Response under Political, Legal and Commercial Pressures*, 36 *Texas ILJ* (2001), 214 (“The main obstacle to a successful EC complaint under the GATT/WTO agreements, however, is Article XXI—the *national security exception*. It is worth quoting the relevant portions of the text: Nothing ... shall ... prevent any contracting party from taking any action which it considers necessary for the protection of its *essential security interests* ... (iii) taken in time of war or other emergency in international relation ...”) (emphasis added). See also Article 73 of TRIPS titled “Security Exceptions” (Article 73(b)(iii) of TRIPS is identical to the corresponding GATT security exception in Article XXI). For this paper, the terms are used interchangeably as essential and national security are generally understood as conveying a similar meaning.

⁹⁶ The conceptualization of the exception was based upon physical defense. See Jurgen Kurtz, *Adjudging the Exceptional at International Investment Law: Security, Public Order and Financial Crisis*, 59 *ICLQ* (2010), 338. However, this conceptualization is outdated due to emerging technology and the U.S.-China rivalry. See Joel Slawotsky, *The Fusion of Ideology, Technology and Economic Power: Implications of the Emerging New United States National Security Conceptualization*, *Chinese Journal of International Law*, <https://doi.org/10.1093/chinesejil/jmab007> (2021).

⁹⁷ See also United Nations Conference on Trade and Development, *The Protection of national security in IIAs*, 22 (http://unctad.org/system/files/official-document/diaeia20085_en.pdf) (“[R]estrictive investment

respond to a dire and imminent peril, show no other viable alternative was available, and provide proof the invoking State was not a contributor to the crisis.⁹⁸ Moreover, while the definition and contours of the security exception are unresolved, there is agreement that nations can invoke the exception only in good-faith.⁹⁹ Restricting the invocation of the security exception to the good-faith principle comports with the need to ensure international stability and exemplified by *pacta sunt servanda*¹⁰⁰ - an important principle applicable when the honoring of commitments is in question.¹⁰¹ *Pacta sunt servanda* is a crucial tenet of international law promoting order and security in global relations which encompasses international economic law.¹⁰²

Indeed, international economic agreements are based upon the principle of domestic law being subordinate to international obligations because without this understanding, nations will act in their own self-interest causing global instability. Therefore, if a state wishes to invoke a treaty exception such as essential security, the invocation must be done in good faith.¹⁰³

The ICJ has interpreted national and international security language in treaties and, unless the language is explicit, has refused to view the clauses as ones whose meaning is left to

measures [...] should only be used as a last resort when other policies cannot be used to eliminate the national security concerns.”).

⁹⁸ This standard which was used the U.S.-Argentinian BIT arbitrations, has been critiqued since “the legal test of ‘necessary’ as expressed in the exception clause and the ‘necessity’ defense in customary international law are separate legal tests”. See Mark McLaughlin, *State-Owned Enterprises and Threats to National Security Under Investment Treaties*, 19 *Chinese JIL* (2020), 320 (discussing how some Argentinian financial crisis tribunals might have conflated the ILC Articles on State Responsibility with the security exception and noting the “precise content of the ‘necessary’ test remains contested”).

⁹⁹ See Chao Wang, *Invocation of National Security Exceptions under GATT Article XXI: Jurisdiction to Review and Standard of Review*, 18 *Chinese JIL* (2019), 710 (States are limited to good-faith invocation of the security exception).

¹⁰⁰ Christina Binder, *Stability and Change in Times of Fragmentation: The Limits of Pacta Sunt Servanda Revisited*, *Leiden Journal of International Law* 25 (2012) at page 911

¹⁰¹ Judith Kelley, *Who Keeps Commitments and Why?: The International Criminal Court and Bilateral Nonsurrender Agreements*, 101 *AM. POL. SCI. REV.* 573, 574 (2007) (Non-signers of the U.S. demand to agree not to turn over U.S. persons to the ICC believed that signing would interfere with the directive of *pacta sunt servanda* and upholding international obligations).

¹⁰² See M. GREEN, *INTERNATIONAL LAW: LAW OF PEACE* 137 (2d ed. 1982) (“*Pacta sunt servanda* (agreements are to be observed) is a rule which predates international law. It applies to all agreements made within the framework of the international legal system, and is the basis of the law of treaties.”); See Michael Wolff, “*Naturzustand und Völkerrecht. Hegel über Kants Idee eines Föderalismus freier Staaten, auf den das Völkerrecht zu gründen sei,*“ in *Join, or Die – Philosophical Foundations of Federalism*, ed. D. H. Heidemann & K. Stoppenbrink (Berlin/Boston: De Gruyter, 2016) at page 200 (Hegel opined that if fulfilling international obligations depended on domestic political and economic considerations global stability would be difficult if not impossible to achieve.) *Id.* at 202 (according to Kant, *pacta sunt servanda* is so vital that non-complying sovereigns are in effect “uncivilized” and not part of the family of nations.)

¹⁰³ See Vienna Convention on the Law of Treaties, May 3, 1969, 1155 U.N.T.S. 331 [hereinafter Vienna Convention] arts. 26, 31(1).

the parties. Its own jurisprudence sets interpretive limits, and in all cases, good faith acts as a background constraint on the ability of states to interpret treaties as they wish.¹⁰⁴

However, two additional reasons create even greater difficulty in evaluating the security exception in our world today. Economic and political factors play an increasingly important role in security exception interpretation not only because of the U.S.-China hegemonic rivalry but also because security interests are impacted by emerging technologies such as AI. Moreover, conceptualizing security is more complex given that developments such as climate change, economic stability, public health and human security may be increasingly viewed as part and parcel of proactive emergency and crisis prevention. Thus, while not new, the “classic tension” between changed circumstances and *pacta sunt servanda* is increased because of emergent technology, transformative factors in global power dynamics and a heightened awareness that preventing socio-economic disasters is an integral part of a sovereign’s obligations.

Re-conceptualizing essential security to encompass non-physical threats, emergencies and crisis

The first priority of any sovereign is the defense of its citizens – protecting national or essential security. Recent arbitration panels corroborate the military defense/territorial integrity narrative of the security exception which reflects the foundation of essential security as based upon defense against attack and ensuring territorial integrity.¹⁰⁵ The 2019 WTO Panel decision in Ukraine discussed the national emergency clause of the GATT security exception within the framework of military conflict and territorial defense. The Panel Report explained the circumstances in this dispute were “very close to the ‘hard core’ of war or armed conflict”¹⁰⁶ defining an “emergency in international relations” as:

a situation of *armed conflict, or of latent armed conflict, or of heightened tension or crisis, or of general instability engulfing or surrounding a state.*¹⁰⁷

Similarly, the 2020 WTO Panel interpreting the TRIPS security exception¹⁰⁸ held essential security interests were connected to defense of the population and territory and triggered when

¹⁰⁴ <https://nyujilp.org/wp-content/uploads/2013/02/40.2-Rose-Ackerman-Billa.pdf>

at 461.

¹⁰⁵ See Jurgen Kurtz, *Adjudging the Exceptional at International Investment Law: Security, Public Order and Financial Crisis*, 59 ICLQ (2010), 338.

¹⁰⁶ Panel Report, *Russia—Measures Concerning Traffic in Transit*, WT/DS512/R (adopted 5 April 2019) at para.7.136.

¹⁰⁷

Panel Report, *Russia—Measures Concerning Traffic in Transit*, WT/DS512/R (adopted 5 April 2019) at para.7.111.

¹⁰⁸ Article 73(b)(iii) is the national security exception of the TRIPS Agreement and is the same as Article XXI(b)(iii) of GATT. The TRIPS security exception allows a State to take “any action which it considers necessary for the protection of its essential security interests’ during the ‘time of war or other emergency in international relations’”.

threats related to the “*defence or military interests, or maintenance of law and public order interests*” are sufficient to establish the existence of an “emergency in international relations”.¹⁰⁹

[T]he [essential security] interests identified [...] are ones that clearly “relat[e] to the quintessential functions of the state, namely, the protection of its territory and its population from external threats, and the maintenance of law and public order internally”.¹¹⁰

In a further exemplar, in the context of the Indian government’s annulment of contracts based on national security, investors filed claims arguing the contracts were improperly negated in violation of an international investment treaty.¹¹¹ In defending the decision to annul the contracts, the Indian government argued its conduct was legal and necessary “for national needs, including the needs of defense, para-military forces and other public utility services as well as for societal needs.”¹¹²

However, and significantly, the decisions limited the Indian government’s justification to protecting military or paramilitary use. The arbitrators agreed that India was empowered to annul the contract based upon the necessity to protect “essential security interests”. Yet with respect to other “needs” such as utilities, railroads, communication and other “societal needs”, such interests did not constitute “essential security”.¹¹³

Clearly, the arbitrators were empowered but declined to extend essential security to encompass “essential needs” [...] These include disaster response, telecommunications, public utilities, and critical infrastructure. That the tribunals could have drawn the line

¹⁰⁹

Saudi Arabia—Measures Concerning The Protection of Intellectual Property Rights Report of the Panel, para.7.257
(<http://docs.wto.org/dol2fe/Pages/SS/directdoc.aspx?filename=q:/WT/DS/567R.pdf&Open=True>).

¹¹⁰

Ibid., para.7.280.

¹¹¹ CC/Devas Award on Jurisdiction and Merits, CC/Devas v. India, paras.211-374; Deutsche Telekom AG v. India, paras.183-291. For an overview of these two rulings, See Prabhash Ranjan, Essential Security Interests in International Investment Law: A Tale of Two ISDS Claims Against India in: Julien Chaisse, Leila D. Choukroune & Sufian Jusoh (eds.), Handbook of International Investment Law and Policy (2020), chp.23.

¹¹² Ibid., para.332; accord Deutsche Telekom AG v. India, ADD cite, para.265.

¹¹³ CC/Devas Award on Jurisdiction and Merits, CC/Devas v. India, paras.354-56; Deutsche Telekom AG v. India, para.281.

differently—for example, to include disaster response but exclude public utilities—only underscores the unanswered questions raised by the collision between state practice and the principles of international economic law.¹¹⁴

Based upon the above-referenced rulings, a sovereign being sued by investors for failing to back-up comfort letters would only be justified in refusing to honor the comfort letter if the nation was somehow in fear of military attack which presumably was connected to the decision not to honor the letter.

But does essential security only refer to defense against physical attack or protecting territorial integrity? In the Argentinian 2001-2002 economic crisis, the sovereign took measures which damaged the economic interests of foreign investors who filed arbitration claims pursuant to the U.S.-Argentine BIT. The tribunal rulings arising from those claims considered the defense of “necessity”¹¹⁵ in the context of economic emergency.¹¹⁶ Generally, claims of economic crisis constituting a threat to essential security were not accepted although the CMS panel did recognize that economic crisis can potentially fall within the conceptualization of essential security.

If the concept of essential security interests were to be limited to immediate political and national security concerns, particularly of an international character, and were to exclude other interests, for example, major economic emergencies, it could well result in an unbalanced understanding of Article XI.¹¹⁷

Interestingly, one panel held public instability can also fall within the ambit of protecting order - which could presumably impinge on territorial integrity.¹¹⁸ Of course, national emergencies should not be overly or easily invoked; “[e]mergency periods should be only strictly exceptional and should be applied exclusively when faced with extraordinary circumstances.”¹¹⁹

¹¹⁴ See J. Benton Heath, *The New National Security Challenge to the Economic Order*, 129 *Yale LJ* (2020), 1044.

¹¹⁵ As noted above, some have criticized the panels with respect to their interpreting “necessity” in those decisions. See Mark McLaughlin, *State-Owned Enterprises and Threats to National Security Under Investment Treaties*, 19 *Chinese JIL* (2020), 320 (discussing how some Argentinian financial crisis tribunals might have conflated the ILC Articles on State Responsibility with the security exception).

¹¹⁶ *CMS Gas Transmission Company v. The Argentine Republic* (ICSID Case No. ARB/01/8), Award, 12 May 2005, para. 317; *Enron Corporation and Ponderosa Assets, L.P v. Argentine Republic* (ICSID Case No. ARB/01/3), Award, 22 May 2007, para. 304; and *BG Group Plc. v. Republic of Argentina (UNCITRAL)*, Award, 24 December 2007, para. 410. *Enron Corporation and Ponderosa Assets, L.P v. Argentine Republic* (ICSID Case No. ARB/01/3), Award, 22 May 2007, para. 313.

¹¹⁷ CMS Award, at para 360

¹¹⁸ See *Continental Casualty Company v Argentine Republic*, ICSID Case no. ARB/03/9, Sept. 5, 2008 at para 174 (serious and extensive public rioting and looting coupled with governmental breakdown might fall within the ambit of “public order”).

¹¹⁹ *LG&E Energy Corp., LG&E Capital Corp., and LG&E International, Inc .v. Argentine Republic* (ICSID Case No. ARB/02/1), Award, 25 July 2007, para. 229.

However, notwithstanding the consistency of conceptualizing security in terms of physical defense (and/or economic crisis so severe that potentially territorial integrity is at-risk), two transformational developments are creating interrelated complexity with respect to interpreting the exception. First, emergent and dual-use technology renders security threats no longer limited exclusively to armed attack or threats to territorial integrity.

Cyber-threats, social stability, economic warfare, environmental threats, and terrorism impinge on national security as much as (or more than) open military conflict. [...] Furthermore, national security is not only military preparedness; national security encompasses a wide range of important bulwarks in defence of the good of the nation such as peace, prosperity, and stability.¹²⁰

In other words, a nation can suffer serious damage to core national interests that are unrelated to territory or military conflict. The idea that states need to defend a more broad-minded understanding of security is exemplified in the perception that states must defend human security as discussed below. Second, the U.S.-China hegemonic contest also raises security interests in a non-traditional fashion.

Beyond Purely Military Threats

Threats emanating from emerging technology (which are not inherently linked to military use but may have dual-uses) may constitute dire security perils and are not defensible via traditional defensive measures. Indeed, a nation can be virtually attacked and its governance systems degraded (i.e., social media interference to demoralize an adversary or manipulate an election), demonstrating many perils cannot realistically be defined as conventional security hazards. Emerging technology such as Central Bank Digital Currencies (“CBDC”) are critical in terms of global power; the extraterritorial sanctions power of the U.S. Dollar is at risk should the role of the U.S. Dollar be reduced. As Former U.S. Treasury Secretary Mnuchin conceded, U.S. Dollar sanctions are a replacement for war.¹²¹ Therefore, reducing (let alone eliminating) the sanctions power of the U.S. Dollar would lead to a massive degradation of U.S. national interests without any connection to a military attack or loss of U.S. territorial integrity. For the U.S., an adversary that strikes at the hegemony of the U.S. Dollar is to some degree attacking the U.S. without firing a shot.¹²² In a real sense, eliminating the sanctions power of the U.S. Dollar is a virtual act of war against the United States since by its own admission, the U.S. wields the U.S. Dollar as a virtual weapon of war. Similarly, if China’s digital Yuan achieves internationalization, efforts at undermining the digital Yuan would similarly strike at core Chinese interests.

Indeed cyber warfare, political interference and CBDCs involve no border disputes and an adversary may have no imminent intent to do physical damage to the other sovereign harm. Yet,

¹²⁰ Joel Slawotsky, *The National Security Exception in US-China FDI and Trade*, 6 *Chinese JCL* (2018) 233.

¹²¹ See Joel Slawotsky, *US Financial Hegemony: The Digital Yuan and Risks of Dollar De-Weaponization*, 44 *Fordham ILJ* 39, 42, n.4 (2020).

¹²² However, deciding whether such a threat constitutes an essential security threat within the meaning of international economic law is clearly impacted by the subjective self-interests of the parties involved.

an extreme threat can be triggered instantly in the future notwithstanding that the threat is not manifested as an immediate danger. Moreover, damaging the core interests of an adversary without physical attack may even be preferred if the “attacking” nation has investments in the other sovereign.¹²³

Enlightened understanding of national interests

National or essential security encompasses a wide range of important bulwarks in defense of the good of the nation such as peace, prosperity, and stability. Doing so comports with notions of defending human security. According to the U.N. Commission on Human Security,

traditional notions of state security must be augmented by an express concern as to, what it terms, “human security”. The driver is a recognition that the contemporary state is no longer able to act as the sole purveyor of security to its people. The challenges to security are now multi-faceted and encompass events often far beyond state control, including risks of external pollution, terrorist attacks and water shortages. These changing risks require a new paradigm of “human security” not as a replacement of state security but as a complementary condition. This notion of human security: “[c]omplements human development by deliberately focusing on ‘downside risks’. It recognizes the conditions that menace survival, the continuation of daily life and the dignity of human beings.”

* * *

The consequences of financial crises – shrinking output, declining incomes and rising unemployment and sharp increases in income poverty – are borne disproportionately by the most vulnerable members of the community.¹²⁴

There are compelling reasons to broaden the horizons of essential security to potentially encompass an obligation to defend human security. While treaty language is important, treaty interpretation should also consult with other aspects of international law.¹²⁵

Rather than essentially inventing an answer to this problem, an adjudicator should apply the rules on treaty interpretation to test the boundaries of this concept. Article 31(3)(c) of the Vienna Convention on the Law of Treaties obliges an interpreter to take into account “any relevant rules of international law relevant in the relations between the parties.”¹²⁶

¹²³ Another scenario is no intent even in the long-term to launch a physical attack. Damaging the core interests without physical attack may even be preferred if the “attacking” nation has investments in the other sovereign.

¹²⁴ See Jurgen Kurtz, *Adjudging the Exceptional at International Law: Security, Public Order and Financial Crisis*, 59 ICLQ 325 (2010) at (fill in) See also https://www.un.org/en/ga/search/view_doc.asp?symbol=%20A/RES/66/290&referer=http://www.un.org/depts/dhl/resguide/r66_resolutions_table_eng.htm&Lang=E (noting the importance of human security to peace and stability).

¹²⁵ While “sources” is preferred, the word “aspects” intends to convey a more nuanced approach. Particularly in terms of defending security, a sovereign might not have the luxury of awaiting emerging sources to mature into “sources” of international law.

¹²⁶ See Kurtz *supra* note (fill in cite)

Accordingly, arbitrations should take into account additional aspects of international law and not merely the investment treaty in question to arrive at an efficient and comprehensive interpretation of the security exception. Resorting to other areas of international law is sensible inasmuch as international law is not static but rather dynamic.¹²⁷

For example, a core state interest particularly in the context of human security is public health. Although the question of whether an interest is essential will be extremely fact specific,¹²⁸ as a general rule, defending against a severe health emergency should qualify as an “essential interest” that must be safeguarded in order to defend national security and the viability of the sovereign.¹²⁹ In recent years, protecting public health has become a more pronounced issue although its conceptualization has been based upon a state’s police power.¹³⁰ The question of police power and investment treaties was considered in *Philip Morris v Uruguay*¹³¹ which held that a plain packaging requirement for tobacco products did not violate international law as the measures were taken by the State to protect public health - a legitimate flexing of police powers. The tribunal cited to a decision by the Claims Commission in the *Bischoff Case* dismissing a claim for damages arising from measures taken against an outbreak of smallpox. In *Bischoff*, the Commission stated: “[c]ertainly during an epidemic of an infectious disease there can be no liability for the reasonable exercise of police powers.”¹³²

Defending public health might be considered a valid exercise of sovereign protection of essential security. For example, in 2020-2021, national governments were obligated to take decisive measures to contain the COVID-19 pandemic such as lockdowns which may damage foreign investors. Yet, in doing so, a sovereign’s actions may – or may not – satisfy international economic obligations since measures would need to be made in good-faith (i.e., not for protectionist aims and in a non-discriminatory fashion). With respect to measures taken to combat the covid-19 pandemic, there might be an impact on financial guarantees. The Delhi High Court’s 2020 ruling in which it reversed its prior ruling preventing the invocation of bank

¹²⁷ *Filartiga v. Pena-Irala*, 630 F.2d 876, 881 (1980) (international law is not fixed but changes over time).

¹²⁸ *LG&E Energy Corp., LG&E Capital Corp., and LG&E International, Inc .v. Argentine Republic* (ICSID Case No. ARB/02/1), Award, 25 July 2007, para. 251.

¹²⁹ For example, the tribunals in the *Suez I*, *Suez II* and *Impregilo* cases held that water and sewage services are essential to the health and well-being of humans and therefore an “essential interest”. *Suez, Sociedad General de Aguas de Barcelona S.A., and InterAguas Servicios Integrales del Agua S.A. v. The Argentine Republic* (ICSID Case No. ARB/03/17), Decision on Liability, 30 July 2010, para. 238; *Suez, Sociedad General de Aguas de Barcelona, S.A. and Vivendi Universal, S.A. v. Argentine Republic* (ICSID Case No. ARB/03/19), Decision on Liability, 30 July 2010, para. 260, and *Impregilo S.p.A. v. Argentine Republic* (ICSID Case No. ARB/07/17), Award, 21 June 2011, para. 346.

¹³⁰ This doctrine, known in its French original “*ordre public et lois de police*” reflects the State’s right to regulate to defend and maintain public order and health.

¹³¹ *Philip Morris Brand Sàrl (Switzerland), Philip Morris Products S.A. (Switzerland) and Abal Hermanos S.A. (Uruguay) v. Oriental Republic of Uruguay* (ICSID Case No. ARB/10/7).

¹³² *Germany – Venezuela Mixed Claims Commission, Bischoff Case* (1903) 10 RIAA 420

guarantees based on the COVID-19 pandemic could not be an excuse for not performing a contract illustrates the relevance of the issue.¹³³

Dynamic Geo-economic Power Dynamics

The world has entered an era of immense political-economic instability; U.S. global hegemony is being challenged by China.¹³⁴ Overall, the United States is not weak and continues to maintain the world's largest military and biggest economy. However, *relatively speaking*, China's impressive achievements have made the U.S. perceive itself (and this may in fact be the reality) as growing weaker compared to China. Chinese technological developments have been striking and range from being a leader in Artificial Intelligence and Quantum Computing to reaching the Far Side of the moon.

The People's Republic of China is now engaged in an economic blitzkrieg—an aggressive, orchestrated, whole-of-government (indeed, whole-of-society) campaign to seize the commanding heights of the global economy *and to surpass the United States as the world's preeminent superpower*. [...] “Made in China 2025” is the latest iteration of the PRC's state-led, *mercantilist economic model*.¹³⁵

It is useful to understand what is behind the claims that in China, a partnership of businesses and State creates a fused threat to the U.S. Large global corporations wield immense power over

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https://indiankanoon.org/doc/123403504/?__cf_chl_jschl_tk__=3c72ae4f911613571e4728423d8c1c7c1f5551e9-1618764581-0-ARgYgPHXbaajmuxB8RepKZVNr8hMHjnP2kmYAzZLcd6gy7ho7gq0kqUgw-lieLSeOQHUUUp7jAj-6G4m1JUCRqcMQBixVLarz_9DTwVUMxhltFm0A_NMCcH3_Mnk-ziQvohroj9U8z12XX4yJ3I8e2LT56M4ZGM5A-xkSOBfKlcrKeQJ6WA-lAlIzfsGqzKB9DTi6qMmIf_5IFenaGKpzNQOxaw_ns0AgFAysk708M0vIWssKn2N3Aud4jGi9KazBpjzA10vVbea04VfQJzFACI6nyECfQzILp_ZUzVtKYA0OB4IW6g9_737P-ra5h32gv5Os8S5C40KIDVEviTUWY06GdBlcFNaXn5q65QINZ2ztWaseunfVC5XLwo5W7XyYT7fKowf-mGaV6eunPQ6XU0zXVd1PqLlScYdabuXaXkJPIDwXhe7TErI3AuAMbAzrHaewRKFNPuLz6Tkx8vNk

¹³⁴ See Kevin Rudd, Kevin Rudd on US-China Relations: This is a New and Dangerous Phase, Australian Fin. Rev. (Jan. 23, 2019), <https://www.afr.com/policy/kevin-rudd-on-uschina-relations-this-is-a-new-and-dangerous-phase-20190122-h1acu6> (“Last year [2018] represented a fundamental strategic turning point in the 40-year history of US-China relations. This is not just an American view; it is also the Chinese view”)

¹³⁵ William Barr, Remarks on China Policy at the Gerald R. Ford Presidential Museum (16 July 2020) (<http://www.justice.gov/opa/speech/attorney-general-william-p-barr-delivers-remarks-china-policy-gerald-r-ford-presidential>). Interestingly, while Barr is critical of China's state-capitalism in his July 2020 remarks, a few months earlier he had suggested the U.S. engage in state-capitalism with respect to 5G. See Really? Is the White House Proposing to Buy Ericsson or Nokia? (<http://www.nytimes.com/2020/02/07/business/dealbook/bill-barr-huawei-nokia-ericsson.html>).

nations.¹³⁶ Moreover, corporate power has increased and the distinctions between State and corporate are at times blurred.

States and corporations are now capable of deploying forces in the field—sometimes states hire corporations that serve as mercenary armies that protect its own operations as well as those of the institutions of the state from sub-national and supra-state threats.¹³⁷

The intensification of the U.S.-China hegemonic rivalry may also serve to highlight the security issue as the ramifications of the new security conceptualization are startling. Does legitimate national security encompass any and all social media and payments platforms? All devices and virtually all Apps are potential data treasures: where does legitimate security end and protectionism and economic jealousy commence? Is there a difference between imposing national security measures against allies versus adversaries? Moreover, the line between defending property and defending economic dominance is not demarcated and is increasingly blurred.

Chinese state-linked firms also implicate China's unique economic governance. The partnering of private actor businesses with governmental ownership under the Chinese economic model is increasingly viewed by U.S. authorities as possessing unfair competitive advantages and in light of the fusion of business, technology and ideology, a national security threat. While the Chinese model is distinguishable as the state's measures to achieve its goals inherently requires that the government establishes the priority in setting overall corporate policies and the balance between political and economic interests. *The economic serves the political*; political interests are dominant and higher than economic interests. Economic or entrepreneurial opposition to political directives is accordingly not acceptable since economic interests are subservient to the political.¹³⁸ Yet China needs capital and dishonoring of comfort letters relied upon by investors may be self-defeating as China is looking to open up its capital markets and internationalize the Yuan.

As described in Part III, the world is facing unprecedented new challenges and a recognition that security is a potentially far-more embracing concept than purely military security. However, balancing this need to expand the contours of essential security lies the risk of overzealous

¹³⁶ See Joel Slawotsky, *The Global Corporation as International Law Actor*, 52 *Virginia JIL Digest* (2012), 84 (“[C]rucial actors in international business and have taken the mantle of economic leadership and development once relegated primarily to nation states.”); Rachel Brewster and Philip J. Stern, *Introduction to the Proceedings of the Seminar on Corporations and International Law*, 28 *Duke JCIL* (2018), 415 (“[L]arge multinational corporations may have greater expertise in understanding international law, particularly as compared to developing states, and use this expertise as a means of resisting and reshaping global regulatory development.”).

¹³⁷ Larry Cata Backer, *The Emerging Normative Structures of Transnational Law: Non-State Enterprises in Polycentric Global Orders*, 31 *BYU JPL* 1, 50 (2016).

¹³⁸ Sherisse Pham, *Beijing just yanked Ant Group's IPO to show Jack Ma who's really in charge* <https://edition.cnn.com/2020/11/04/tech/ant-ipo-beijing-china-intl-hnk/index.html> Nov 4, 2020 (“Beijing just showed tech titan Jack Ma and the rest of China's billionaire tycoons who's really in charge.”)

invocation. Doing so would do significant damage to *pacta sunt servanda* and risk harm to trade and investment. Accordingly, examining whether the exception should be expanded to a specific factual context requires examining the issue within the rubric of vigorous good-faith which is discussed in the next Part both with respect to the security exception as well as comfort letters.

IV When *Pacta Sunt Servanda* and National Emergencies Collide: Potential Guidelines for Arbitration Panels

In our hypothetical situation, debt investors have filed claims in local courts and have either been rejected outright or accepted but enforcement blocked by the sovereign. The investors will then examine whether a relevant investment treaty might afford the investors an alternative venue to recovery by claiming the sovereign's actions violated the guarantees provided in the international economic agreement. Undoubtedly, the sovereign would endeavor to resort to one of the escape clauses in the investment treaty such as the right to override the treaty's investor protections to protect the nation's essential security. The initial step is to ascertain whether there is a security interest that needs to be protected and was it invoked in good-faith. If the answer is yes, the investors' claims would presumably be dismissed. If the answer is negative, the panel will need to examine whether a legitimate claim exists based upon an alternate theory such as promissory estoppel. Does enforcing the comfort letter via estoppel in the particular context comport with good-faith?

There are no easy answers and the approach articulated below is merely offered as a suggested model for panels to examine - there is no one all-encompassing model. The panel will need to ascertain whether an exception permits taking into account an expanded understanding of risks encompassing national interests far beyond the strictures of military conflict and/or territorial integrity. Clearly, disaster relief, infrastructure and poverty alleviation may be potential factors that could lead to invocation of the security exception based upon an expanded conceptualization of security. The additional dimension of radically transformative emerging technology adds an additional dimension of complexity. Naturally, the slope is slippery and creates enhanced risks of an overzealous invocation. As a guardian against abuse of invoking the security exception and with respect to whether the letter can be enforced, the principle of good-faith it is argued is "the" tonic and must be enforced resoundingly in favor of parties acting in good-faith and against those acting in bad-faith.

A Pacta sunt servanda: Good faith and the essential security exception

Re-conceptualizing essential security is a must; arbitrators must recognize these sweeping global changes and reshape their decisions accordingly. But arbitrators should examine the issue within the framework of *pacta sunt servanda* to balance the tension inherent between domestic considerations versus economic obligations when sovereigns seek to override contractual obligations. While balancing the tension is not new nor is has it really ever been simple, as the world undergoes dynamic technological changes¹³⁹ and great power rivalry, there are increasing

¹³⁹ Revolutionary emerging technology such as AI will dramatically transform the world. Lutz-Christian Wolff, *Artificial Intelligence ante portas: The End of Comparative Law?*, *The Chinese Journal of Comparative Law*, Volume 7, Issue 3, December 2019, Pages 484–504

difficulties. According to the Vienna Convention on the Law of Treaties (“VCLT”) Art. 61 and 62, international law generally provides for some room to accommodate change due to fundamental changes. However, the substantive criteria for flexibility are most restrictive;¹⁴⁰ necessity for example is a justifiable principle to derogate, under certain circumstances, from otherwise applicable international obligations.¹⁴¹

Here good-faith is the elixir that can smooth the process of treaty interpretation. As exemplified in the VCLT, good-faith is a primary rule of public international law and principle of treaty interpretation – widely perceived as black-letter law.¹⁴² Art. 27 explicitly underscores, parties “may not invoke the provisions of its internal law as justification for its failure to perform” – therefore domestic law is subordinate to international treaties.¹⁴³ Accordingly, good-faith is the ultimate component in evaluating disputes; *pacta sunt servanda* as embedded in the VCLT obligates nations to execute obligations (including the invocation of any treaty exceptions) in good faith.¹⁴⁴

Good Faith in an Era of Shifting Power Balances: Expanding Notions of Extraterritoriality and Jurisdictional Statecraft

Increasingly, legal concepts of extraterritoriality and jurisdiction are crossing the rubicon to encompass geo-economic strategies. For example, in IP litigation, recent rulings in India and China indicate that sovereigns are endeavoring to engage in legal-economic leverage through resort to injunctions and/or obtaining extraterritorial jurisdiction.¹⁴⁵ The more active U.S. position on utilizing national security such as Executive Orders on Chinese corporations as well as the cross-over of security to impact capital market regulation is an important development and significant departure from a “territorial defense” based security conceptualization.¹⁴⁶

China has also re-emphasized and enhanced its rights to exercise extraterritorial jurisdiction. For example, China’s Hong Kong National Security Law contains no geographic limitation, encompassing conduct committed by anyone and anywhere, that harms the national security of Hong Kong.¹⁴⁷ China’s Draft Data Security Law which broadly conceptualizes “security

¹⁴⁰ Christina Binder, Stability and Change in Times of Fragmentation: The Limits of Pacta Sunt Servanda Revisited, *Leiden Journal of International Law* 25 (2012) at 915.

¹⁴¹ *Id.* at 916-7.

¹⁴² See VCLT Art. 26. See also Davison-Vecchione, Beyond the Forms of Faith: Pacta Sunt Servanda and Loyalty, *German Law Journal* 16, no. 5 (2015) 1165 (the principle has not been challenged in courts it is understood to be non-derogable).

¹⁴³ See VCLT Art. 27.

¹⁴⁴ Daniel Davison-Vecchione, Beyond the Forms of Faith: Pacta Sunt Servanda and Loyalty, *German Law Journal* 16, no. 5 (2015) 1166.

¹⁴⁵ Cite the rulings

¹⁴⁶ Cite Executive Orders in We Chat, Tik Tok also potential delisting of shares traded on US exchanges

¹⁴⁷ See Hong Kong national security law full text (2 July 2020) (<http://www.scmp.com/news/hong-kong/politics/article/3091595/hong-kong-national-security-law-read-full-text>) (Article 38 states: “[t]his Law shall apply to offences under this Law committed against the Hong Kong Special Administrative

interests”¹⁴⁸ and encompasses extraterritorial jurisdiction. The Draft Data Security Law is applicable to “‘data activities’ within China, but it also states that organizations and individuals *outside of China that conduct data activities which may harm China’s national security, public interests, or the rights of Chinese citizens may be subject to this law*”.¹⁴⁹ China’s new Export Law also notes the extraterritorial application of the law.¹⁵⁰

Good faith and Chinese economic governance

As discussed above in Part III, China’s economic governance is unique; an architecture encouraging profits similar to all other market economy models but simultaneously fundamentally distinguishable. In China, the economic serves the political; political interests are superior, dominate and are primary. Of course, this does not necessarily imply bad-faith and as a sovereign seeking to expand its market footprint by attracting FDI and opening up its financial markets, China has a strong incentive to act in good-faith and comply with contractual obligations. Therefore, self-interest in being able to attract capital may not necessarily trump political interests particularly if such interests are not implicated in a given context. Nevertheless, arbitrators will need to incorporate an understanding of the political-economic dynamic when applying good-faith especially when political interests are indeed implicated.

In sum, the de-linking territorial integrity and military conflict from defense of core national interests is sensible inasmuch as emergent technology (and emergencies and crisis if severe enough) could so degrade a sovereign that national weakness may incentivize a terrorist strike or embolden a foreign State to militarily attack the nation. Doing so is in keeping with the narrative that the security exception is applicable in support of physical defense of the national bastion permitting nations to override contractual obligations to defend national security grounded in the fundamental right of self-defense in international law. However, even without the threat of military conflict, emergent technology makes clear that crucial national interests might be severely damaged without any crossing of borders. Protecting sovereign property (and not merely physical borders) encompasses defending important industries, national champions, IP, data and virtual assets. Doing so is defending the nation’s security interests which is the primary directive of any government. For the reasons explained above, the inquiry of good faith is absolutely vital in an era of paradigm-shifting conceptualizations of security.

Region *from outside the Region by a person who is not a permanent resident of the Region.*”) (emphasis added).

¹⁴⁸ Yan Luo and Zhijing Yu, China Issued the Draft Data Security Law Inside Privacy (3 July 2020) (<http://www.insideprivacy.com/data-security/china-issued-the-draft-data-security-law/>) (discussing Draft Data Security law defining “data security” as a compilation of data that may affect China’s national security, economic security, social stability and public order).

¹⁴⁹ Id. (referencing Article 2 of the Draft law) (emphasis added).

¹⁵⁰ See PRC Export Control Law (unofficial translation) (26 October 2020), art. 44 (http://www.cov.com/-/media/files/corporate/publications/file_repository/prc_export_control_law_2020_10_cn_en_covington.pdf); China Issues New Export Control Law and Related Policies (26 October 2020) (<http://fas.org/sgp/crs/row/IN11524.pdf>) (China’s new law encompasses extraterritoriality).

B *Pacta sunt servanda*: Enforcement of Comfort Letters Via Estoppel and Good Faith Reliance

Notwithstanding the need to expand the horizons of “security” as noted above, presuming that arbitrators do not find a justification to invoke the exception, the panel might need to evaluate the comfort letter. To the widest extent possible, dishonoring contracts is to be strongly discouraged as contract compliance proximately causes a stable environment and business confidence. Global governance and commerce depends upon basic trust and if this is broken, economic relations and global governance will be damaged.

Accordingly, arbitrators should examine the issue of the enforceability of a comfort letter within the framework of *pacta sunt servanda* and analyze the enforceability of the specific comfort letter pursuant to a standard of utmost good-faith. The standard of exacting good-faith should be on both sides including the extent of any nefarious intent as well as the level of sophistication of investors. For example, a letter issuer who re-routes money borrowed by a subsidiary to the parent might incentivized to engage in gross negligent, excessive risk-taking or even fraud if it believes it has an escape hatch of claiming the letter is no guarantee.

[Comfort letters] commit bond issuers’ parent companies to maintain an offshore subsidiary’s financial strength so that it can meet repayments, according to Fitch. The rating agency says they are “essentially a strongly worded letter of comfort” and do not create a direct debt liability for the parent companies of bond issuers.¹⁵¹

However good faith runs two ways – was the sophisticated and forewarned of the risks but simply decided to take the risk?

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What is the motivation to lend without an express guarantee? As noted above, ZIRP and a generally minimalist interest rate environment provides greater leverage to borrowers in setting terms – a borrower’s market. If the issuer of the comfort letter is state-linked this also can blur the normal due diligence framework as presumably a state wants to avoid reputational harm to state-linked entities. Market factors also play a role – perhaps the prospect of a longer-term profitable relationship or a lender that seeks to enter new commercial territory and “break-in” to competitors’ turfs. Sophisticated lenders might simply be taking a market bet or might be forced to in the hunt for yield. Arbitrators should endeavor to determine whether recover is possible under an estoppel theory. Promissory estoppel might prompt a court to find the letter issuer knew

¹⁵¹ Edward White, Foreign investors face critical legal test for \$82bn in China bonds <https://www.ft.com/content/8a30b7b8-864d-4478-a130-aeabd51863da> April 8, 2021

¹⁵² Edward White, Foreign investors face critical legal test for \$82bn in China bonds <https://www.ft.com/content/8a30b7b8-864d-4478-a130-aeabd51863da> April 8, 2021

or should have known (reasonably) that the lender would rely on the letter even in the absence of a formal contract or written guarantee.

For example, a party buying crude oil products issued a letter to the borrower's bank assuring bank of the letter issuer's intent to buy the products from the borrower and that it would directly deposit the purchase price into the bank at a certain date. Relying on the letter, the bank provided loans to the borrower (the seller of the oil products). The court stated:

No matter how the language of this telex is characterised – as a “guarantee”, an “undertaking”, a promise to pay ... or merely a “comfort letter” confirming the terms ... the agreement embodied in this telex could arguably be deemed inseparable from the contract, and its construction therefore is a matter for the arbitrator.¹⁵³

But again, good-faith in both directions is crucial. While the doctrine of good faith is particularly appropriate when the text of the letter has been purposely drafted with an intent to deceive which causes good-faith detrimental reliance, good-faith should be applied vigorously in any context.¹⁵⁴ Arbitrators should enforce the letter on a theory of promissory estoppel not only if there are purposeful ambiguities but even when the opaqueness is not intentional. Of course, if there was no good-faith reliance by the investors that is a considerable factor for arbitrators to weigh in examining an estoppel theory.

Therefore, if the creditor can demonstrate good-faith reliance on the letter – and that such reliance was reasonable *based upon the totality of the circumstances* – the letter might be enforceable as an implied contract based upon promissory estoppel. The decision in *Lasalle Bank National Association v Citicorp Real Estate Inc.*,¹⁵⁵ is instructive. According to the ruling, to resolve whether an implied contract existed under an estoppel theory, the court noted an array of useful factors to inform a judicial decision: the wording of the letter; the overall context in which the letter was provided; the sophistication of the parties; prior transactions and relationships; the understanding of such letters in the specific business area; whether attorneys were involved; unwritten representations if any; whether the creditor was reasonable in relying upon the letter under an implied contract,¹⁵⁶ promissory estoppel or detrimental reliance theory.¹⁵⁷ Enforcing a

¹⁵³ See *Banque de Paris et des Pays-Bas v Amoco Oil Co.*, 573 F Supp. 1464, 1473 (S.D.N.Y. 1983).

¹⁵⁴ *Lasalle Bank National Association v Citicorp Real Estate Inc.* (plaintiff's reliance on the letter was unreasonable; specifically, the plaintiff as a large global financial institution was sufficiently knowledgeable that the reference to the letter being a comfort letter indicated no express guarantee was intended.)

¹⁵⁵ 2003 US Dist LEXIS 12043 (SDNY July 18, 2003).

¹⁵⁶ Bernstein and Jakoll *The Gentleman's Agreement in Legal Theory and in Modern Practice: United States* (1998) 46 *American Journal of Comparative Law* 87 at 100 (“The parent company, however, may find itself held liable as a guarantor when a court considers the letter in the context of the whole relationship among the three parties and finds it to be part of an implied contract.”)

¹⁵⁷ 2003 US Dist LEXIS 12043 (SDNY July 18, 2003) at 25-26 citing Herbert Bernstein and Joachim Zekoll, “The gentleman's agreement in legal theory and modern practice” *The Gentleman's Agreement in Legal Theory and in Modern Practice: United States* (1998) 46 *American Journal of Comparative Law* 87 at 98-101.

comfort letter based upon a consideration of these factors comports with the increasingly accepted approach is to conceptualize the contract on a more holistic and reduced emphasis on requiring a formalistic contractual framework in order for the statement to be enforceable.¹⁵⁸

Good-faith and the conundrum of Chinese state-linked entities

As noted above, China's economic governance is novel and distinct from the Western market-capitalism models which ostensibly separates the political interests from economic interests. As a state-centric model, directed by the ruling CCP, economic interests serve the political. Yet this does not translate into automatically finding bad-faith or the lack of good-faith but when political-economic interests are implicated, arbitrators need to incorporate into their analysis the unique economic governance in China and the fact the political interests dominate over the economic.

State-linked entities of course want to amass profits and the earnings motive motivates decision-making – but there are concerns that their ultimate controller is a state makes ascertaining good-faith a more multi-faceted inquiry.

Will a Chinese parent recognise its contractual obligations under a keepwell deed, which literally gave the impression to offshore bondholders the deeds are equivalent to a guarantee?" the person said, adding that "the Chinese parent actually took the majority of subscription proceeds back to China for its own use".¹⁵⁹

¹⁵⁸ See Lutz-Christian Wolff, The relationship between contract law and property law, 19 Common Law World Review (2020) 33, (Noting "[c]ontracts are seen as relationships consisting of promises which are enforceable by law." The prevailing view is to "treat a 'contract' as a cluster concept" and through the prism of transactions based on "a promise (express, implied, imputed, or constructed); and that a promise will constitute a contract where it (i) is reciprocated by a requested act of performance; or (ii) is reciprocated by a promise; or (iii) is intended to, and does, induce reasonable reliance or expectation." (emphasis added).

¹⁵⁹ Edward White, Foreign investors face critical legal test for \$82bn in China bonds <https://www.ft.com/content/8a30b7b8-864d-4478-a130-aeabd51863da> April 8, 2021

To be sure, the opening up of Chinese financial markets is a national priority and bad-faith would seriously damage the willingness of creditors to invest in China.¹⁶⁰ Therefore, China has a strong incentive to act in good-faith and comply with contractual obligations. Self-interest in being able to attract capital may or may not trump political interests if such interests are implicated in a given context. Nevertheless, arbitrators will need to incorporate an understanding of the political-economic dynamic when applying good-faith. And this is also applicable to investors: arbitrators will also need to consider the fact that the economic governance of foreign investors might be distinct from China's governance and how this might shape the expectations of the foreign investors and might potentially shape the arbitrator's evaluation of good-faith on each side. For the reasons explained above, the inquiry of good faith is absolutely vital in determining whether a comfort letter is enforceable.

V Conclusion

By incorporating a two-step approach and applying good-faith vigorously, arbitrators could balance the demands of transformative global changes (and/or crisis) with the crucial significance of comporting with *pacta sunt servanda* and the honoring of contracts. Doing so is also a marker of a flexible yet predictable evaluation of the circumstances. Parties would be on notice that rather than relying on plausible deniability, i.e., we had no intention to guarantee the payment see the language used, the parties' conduct and relationship will be vital in determining the enforceability of the letter.

The context of Chinese corporate debt brings to the forefront an inherent tension between sovereign discretion, accountability to citizens and the nation's obligations under international law. Investment treaties curtail a sovereign's discretion by legally binding states to guarantees agreed upon by the parties but provide for an escape from the obligations via exceptions permitting states to derogate from their contractual commitments. However, principles of international law are also applicable to treaties including *pacta sunt servanda*. While a more liberal conceptualization of security is worthy of consideration, an overly-expansive conceptualizing risks a slippery-slope whereby eventually the exception might swallow the rule. Moreover, any sovereign defaulter will have to balance the effects of allowing a default and potential alienation of investors with the demands of defending a legitimate essential security interest. The future ability of state-linked entities (or the sovereign itself) to borrow or to enjoy a preferential interest rate due to reputational harm and/or the realization the comfort letter is meaningless is a factor sovereigns must also consider. With respect to China, developing the capital markets is an important developmental goal towards building a de-dollarized financial architecture. The balancing of rights between Chinese state-linked letter issuers and investors implicates a dynamic mix of issues: protection of a sovereign, stability in markets, legal certainty in international economic (and political) relations and of course good-faith which is inherent in *pacta sunt servanda*. Ultimately, the role of good-faith cannot be over-stated and must be

¹⁶⁰ Treating foreign investors unfairly or not supporting state-linked entities would probably increase interest rates for state-linked borrowers going forward. See <https://privatebank.jpmorgan.com/gl/en/insights/investing/our-takeaways-on-the-huarong-situation>

vigorously employed in any decisions on comfort letters whether by domestic courts or international arbitration tribunals.