

## Compliance with Transnational Commercial Law Treaties—A Framework as Applied to the Cape Town Convention

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# Compliance with Transnational Commercial Law Treaties – A Framework as Applied to the Cape Town Convention

Jeffrey Wool★

*Modern commercial law treaties are designed to produce economic benefit. Yet their ability to do so depends on whether transacting parties and risk assessors can reasonably assume that contracting states comply with their treaty obligations. That includes where precedent is absent, which is always the case in the early period of a treaty system. This article sets out a core conceptual framework to assist in understanding commercial law treaty compliance. It starts with threshold questions such the nature and meaning of compliance, then turns to measuring compliance, and, absent sufficient data to do so, to modelling expectations of compliance. It addresses the consequences of non-compliance, and, finally, what can be done in practice to enhance compliance, all in the context of modern commercial law treaties. The article then applies this framework to the specific case of the Cape Town Convention and its Aircraft Protocol, and concludes that, while country specific, expectations of compliance should generally be high for these instruments, and could be made higher by select action, much of which is actively being undertaken.*

## I. Introduction

In previous writing,<sup>1</sup> we have underscored the principal objective of modern commercial law treaties: the production of economic benefit

(‘EB’).<sup>2</sup> These instruments, a subset of the larger field of transnational commercial law, are substantive treaties specifically designed to facilitate a transaction type (‘Transnational

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<sup>1</sup> See Jeffrey Wool, ‘Treaty Design, Implementation, and Compliance Benchmarking Economic Benefit – a Framework as Applied to the Cape Town Convention’, (2012) 27 *Uniform Law Review* 633.

<sup>2</sup> Economic benefit can take several forms. The main ones are micro, macro, and developmental. By *microeconomic*, we mean enhancing the commercial attractiveness of a transaction, whether by stimulating it or making it more efficient, for example, by reducing the risk in or cost of the transaction. *Macroeconomic benefits* are benefits that flow from the microeconomic ones: these include benefits to consumers, increased employment, greater levels of trade, investment, or liquidity, and better allocation of governmental resources. *Developmental economic benefits*, in turn, flow from the macroeconomic ones: these are broader advantages that benefit society as a whole through, for example, enhancement of physical infrastructure, strengthening of trading systems, and reduction of external debt.

Commercial Law Treaties', in short, 'TCL Treaties'). Though epitomized in the Convention on International Interests in Mobile Equipment ('Convention') and its Aircraft Protocol ('Aircraft Protocol'),<sup>3</sup> several treaties developed since the 1980s fall into this grouping.<sup>4</sup>

In that writing, we asserted that benchmarking EB should be centred on the formula:

**EB = RIC**, where: **R** means the TCL Treaty's ability to reduce transaction risk; **I** means the effective implementation of the TCL Treaty, and **C** means state compliance with the TCL Treaty, actual or presumed.

In this article, we build upon the foregoing by focusing on the concept of *compliance by states* that have ratified or acceded to TCL Treaties ('contracting states'). Since non-implementation of a TCL Treaty<sup>5</sup> is an act of non-compliance, as discussed below, we will, as the context warrants, use 'compliance' as the umbrella term. In other words, 'I' is subsumed in 'C', simplifying the formula to **EB = RC**. This formula is depicted in Annex I.

The article provides a conceptual framework for understanding compliance with TCL Treaties. The framework is then applied to the case of the Convention and Aircraft Protocol

(together, 'Cape Town Convention', or, in short, 'CTC'), rather than the other protocols to the Convention.<sup>6</sup>

Part II sets out that framework ('Treaty Compliance Framework'). The Treaty Compliance Framework is built around the following five core questions:

1. What is the nature and meaning of compliance in the context of a TCL Treaty?
2. What evidence is available to measure compliance with a TCL Treaty?
3. What are the expectations of compliance with a TCL Treaty, and how can they be modelled?
4. What are the consequences of non-compliance with a TCL Treaty?
5. How can compliance with a TCL Treaty be enhanced?

These are complex questions deserving detailed and separate treatment. Given practicalities, we can only skim the surface on these questions. Our focus is on placing them in a broader context. Part III will then apply the Treaty Compliance Framework to the CTC. Part IV will set out some concluding comments.

## II. Treaty compliance framework

Preliminary note: in Part II, we will use and refer to the basic paradigm of a prototype TCL Treaty ('treaty-p') in force multilaterally among a number of contracting states including one ('state-x') whose compliance or potential compliance is being assessed or relied on by a transacting party ('party-y') formed under the laws of, and whose centre of administration is in, another contracting state ('state-y'). Treaty-p is a complex instrument, both in terms of subject matter (addressing property and

<sup>3</sup> *Convention on International Interests in Mobile Equipment and Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment*, each adopted in Cape Town, 16 November 2001.

<sup>4</sup> These are the treaties addressing financial leasing, factoring, receivables financing, and intermediated securities. Many points made in this article would not apply to or be correct in the context of other treaties, though there are some common elements in the case of treaties addressing contracts generally and transport of goods by air, sea, rail, and road, at least the extent that these treaties seek to facilitate such transport or contracting and/or reduce their transaction costs (rather than setting out a set of rules seeking to balance legal systems or the interests of the transaction parties).

<sup>5</sup> For detailed and separate treatment of implementation issues, see Jeffrey Wool and Andrej Jonovic, 'Relationship between Treaties and National Law – a framework as applied to the Cape Town Convention' (2013) *Cape Town Convention Journal* 65. A few parts of the current article, covering the same items in summary form, make use of text and references from the foregoing article, with permission.

<sup>6</sup> This article does not address the (i) *Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Railway Rolling Stock*, adopted in Luxembourg, 23 February 2007, or (ii) *Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Space Assets*, adopted in Berlin, 9 March 2012. Neither the Rail Protocol nor Space Protocol is in force.

insolvency law, in addition to contract law) and structure and content (with *sui generis* concepts created by the treaty, a large numbers of defined terms, elaborate cross-referencing, and the like). The points made about (i) treaty-p should be generalised to TCL Treaties, (ii) state-x and state-y should be generalised to contracting states to TCL Treaties, and (iii) party-y should be generalised to parties to transactions governed by TCL Treaties ('transacting parties').

We now take up each element of the proposed Treaty Compliance Framework.

### 1. Nature and meaning of compliance in the commercial law treaty context

#### (a) Definition and main elements of compliance

The threshold task is to define 'compliance' for our purposes. First, what it is not: we are not concerned with when and whether party-y takes action in accordance with treaty-p. Rather, we are concerned exclusively with acts or omissions by state-x. State-x, which where applicable includes its legislative, judicial, executive, and administrative organs at all levels of government, complies with treaty-p when it:

- (i) takes all action to ensure treaty-p has the force of national law with priority over conflicting national law (we define this element as 'implementation'). In other words, all matters within the scope of treaty-p are governed by its terms; and
- (ii) fully and accurately applies the operative treaty-p terms to actions and disputes within its scope, whether judicially or administratively. This includes, but is not limited to, performance of obligations placed on state-x under treaty-p.

In short, state-x complies with treaty-p where the latter legally applies, and is fully and accurately applied to all matters within its scope.

#### (b) Main sources of non-compliance

Utilising/Applying the above definition, we set out the main sources of potential

non-compliance with treaty-p. These are depicted in [Annex II](#), grouped as relating to (i) implementational non-compliance, (ii) unintentional non-compliance, or (iii) intentional non-compliance. These groupings relate *inter alia* to the nature and effectiveness of preventative and remedial action and steps that may enhance compliance.

(i) Non-compliance may be caused by non-implementation ('implementational non-compliance'). Treaty-p may not have been implemented, and thus may not serve as the prevailing law governing matters within its scope. The main reasons for implementational non-compliance are insufficient action by state-x, most likely the absence of needed legislation (to ensure the force of national law<sup>7</sup> or priority over conflicting national law) or the operation of adverse hierarchical rules (which result in the priority of conflicting national law). On the latter, the most common cases involve those systems in which the principle of *lex posteriori* applies,<sup>8</sup> and a subsequent conflicting law has been enacted, or in which

<sup>7</sup> While treaty-p binds its contracting states and creates inter-state responsibilities and liability, see *Vienna Convention on the Law of Treaties*, 1969 (the 'Vienna Convention'), the principal authoritative source of treaty law, at art 26, among others, the threshold question for party-y seeking to rely on treaty-p is whether the instrument has the 'force of law' in state-x. By that, we mean the following: will national courts and administrative officials enforce and/or apply the treaty-p provisions as national law in a transactional setting. As international and national law operate on different planes, 'entry into force' of treaty-p by state-x is a necessary, but not sufficient, condition to its having force of national law. State-x cannot invoke the provisions of its national law as justification for failure to perform treaty-p. See Vienna Convention, art 27; see art 46 for a restricted exception to this rule. Whether and the extent to which treaty-p has the force of national law is determined by national law, usually constitutional in nature. In that regard, the threshold question is whether treaty-p needs to be incorporated or transformed into state-x's national law by legislation or a further legislative-type act or process.

<sup>8</sup> For our purposes meaning: a later in time law prevails over an earlier in time one, of equally hierarchical rank.

the principle of *lex specialis* applies,<sup>9</sup> and a more specific law exists or is enacted. Few issues of implementational non-compliance arise<sup>10</sup> in countries where a treaty is *per se* the *highest legal norm*.<sup>11</sup> Implementational non-compliance may be, and often is, remedied by further legislative or regulatory legal activity.

(ii) Non-compliance may be caused by acts or omissions not intended to have that effect ('unintentional non-compliance'). In this category, the failure to fully and accurately apply treaty-p is attributable to *informational and educational issues*, on the one hand, or *institutional issues*, on the other, which state-x seeks or would seek to address constructively. In the case of the former, officials and judges may have limited information or understanding about the content of treaty-p. That is more likely when the government did not actively participate in the treaty negotiations or did not undertake adequate educational activity in connection with its ratification. The further treaty-p's content is from existing national law,<sup>12</sup> and the more limited the local language educational materials, the greater the risk of this type of non-compliance. Institutions in a contracting state may lack working rules or procedures or otherwise be unprepared to discharge the terms of treaty-p. Unintentional

non-compliance may be, and often is, remedied by enhanced education and improved regulation and/or procedures.

(iii) Non-compliance may be caused by acts or omissions intended to have that effect or whose treaty-violating consequences are disregarded, generally or specifically, by state-x ('intentional non-compliance'). In this category, the failure to fully and accurately apply treaty-p is attributable to a decision to have, or indifference that, a non-treaty rule (or no rule) govern(s) a matter within the scope of treaty-p, or more broadly to a general disregard for the rule of law. The underlying or specific cause could range from a government policy, to protectionism or favouritism, to corruption. These risks are often (if loosely and not always accurately) labelled as 'country risks' or 'political risks'. We prefer and will use the phrase 'rule of law risk'. Intentional non-compliance may well be systemic, and, thus, difficult to remedy: it would require rooting out of the underlying cause, at least in the specific context of treaty-p.

#### (c) Borderline cases

Treaty-p seeks to reduce transaction risk, thus producing economic benefit. That risk reduction requires that treaty-p *clearly and comprehensively* address the core legal questions applicable to the subject transaction. Accordingly, treaty-p should be (i) drafted as precisely as possible, (ii) centred on rules, not standards, (iii) closed not open-textured, (iv) broad in scope,<sup>13</sup> and (v) the subject of official detailed materials on intent and interpretation.

However, that is not always the case. Even the most clear and comprehensive texts leave some items open or susceptible to differing, but reasonable, interpretation on scope and content. These items raise 'borderline cases' of compliance. The main categories of borderline areas for treaty-p are as follows:

(i) Treaty-p's complexity inevitably presents *bona fide* questions of *textual interpretation*, despite (a) rules in treaty-p that demand

<sup>9</sup> For our purposes meaning: a more specific law prevails over a more general one, of equal hierarchical rank.

<sup>10</sup> But see discussion of unintentional non-compliance below.

<sup>11</sup> For our purposes meaning: treaty-p *per se* prevails over all conflicting law (save, where applicable, constitutional-type law). That is the case in many legal systems. In such countries, treaty-p prevails over conflicting non-treaty law enacted later in time. Where treaties are the highest legal norm, the relevant issues are (i) whether all necessary procedural requirements were met to ensure primacy of the treaty-p, (ii) whether treaty-p actually conflicts with national law, and (iii) whether there is a subsequent treaty which conflicts with treaty-p.

<sup>12</sup> This is subject to debate. There is a countervailing view that a new international best practice-type norm (which treaty-p would constitute for many contracting states) provides an opportunity for sweeping institutional reform to existing, but ineffectual, legal institutions.

<sup>13</sup> For example addressing dispute resolution, thus avoiding resort to uncertain rules of private international law.

an autonomous interpretation<sup>14</sup> (given its international character and need to perform uniformly in application<sup>15</sup>), and (b) rules in the Vienna Convention addressing interpretation.<sup>16</sup> Where vague and open-textured wording (such as public order or interest, good faith, and reasonableness) is used without limiting parameters, the risk of borderline cases and compliance-related uncertainties is substantially increased.

(ii) The most challenging category of borderline compliance issues arise when there are ‘gaps’ in the treaty-p text, perceived or actual. Such gaps are first to be filled in conformity with the general principles on which the text is based (rather than national law, which is only referred to absent such principles). These general principles create a penumbra requiring application of treaty-p’s principles.<sup>17</sup>

<sup>14</sup> While comparative assessments of national law were relevant to the details and characteristics of the treaty-p provisions, once so created by the instrument, they stand as autonomous constructs. We refer to the foregoing as the ‘autonomous interpretation principle’. This point is well made by Van Alstine, ‘Dynamic Treaty Interpretation’ (1998) 146 *University of Pennsylvania Law Review* 687, 730-31: ‘...interpretation of a private law convention must proceed on the basis of its ‘international character’. This directive serves a separating and elevating function. That is, it suggests an ‘autonomous’ interpretation free from the influence of national legal concepts and terminology, and even from the domestic interpretive techniques themselves. In doing so, this mandate amounts to an express direction to interpreters to view a convention as occupying an entirely different, elevated international dimension’.

<sup>15</sup> TCL Treaties differ in the extent to which they also require courts to take into account ‘good faith in international trade’ (increasing the risk of borderline compliance issues) and the ‘need to promote predictability in application’ (reducing the risk of borderline compliance issues) in their interpretation. In our modelling below, we assume that treaty-p included the latter, not the former.

<sup>16</sup> Vienna Convention, arts 31 and 32. The rule consists of three elements: the text (provisions), context (preamble and annexes), and object and purpose (usually also in the preamble). In addition to context, subsequent agreement on application or interpretation and practice are also to be taken into account.

<sup>17</sup> Much follows from the autonomous interpretation principle, including that a penumbra or periphery exists

Yet, depending on the degree to which the text and supporting materials provide sufficient definition, questions may remain on the precise content and implications of such general principles and what is within and outside of that penumbra. To the extent that legitimate questions are present, the position on compliance is unclear. This matter is fact-specific.

(iii) National law remains relevant to the application of treaty-p where the latter expressly refers to the former, as is often the case. Such references to national law (usually to the ‘applicable law’) – often on sensitive and complex issues – reveal the hybrid nature of treaty-p, mixing substance and conflicts features. For our purposes, they represent a third borderline area, since, in this case, *incorrect or prohibited application of national law*, including where state-x applies the law of state-y, constitutes non-compliance. Ensuring that the legal facts are sufficiently clear to assert non-compliance in this context may be difficult. This too is fact-specific.

(iv) Treaty-p is a classic ‘private law’ instrument, mainly addressing the rights of transacting parties. The traditional view, though generally unstated in the text, is that such an

requiring application of treaty-p’s substantive terms or those implied thereby – to the exclusion of otherwise applicable national law – to the extent set out below. These are issues that relate to or otherwise directly or indirectly impact core concepts in treaty-p and/or the rights and obligations of party-y and the other transacting parties thereunder (‘penumbra issues’). This extended scope is express: treaty-p contains a clause that requires that, in the first instance, gap filling (‘questions concerning matters governed by [treaty-p] which are not expressly settled in it’) is to be done ‘in conformity with the general principles on which [treaty-p] is based’ (emphasis added). In some TCL Treaties, the same conclusion is implied from the autonomous interpretation principle. If, and only if, no general principle applies to a penumbra issue, then the gap is filled by the applicable law. For such TCL Treaties, the autonomous interpretation principle and related clauses support a wide application of a TCL Treaty’s substantive terms and principles to many, if not most, penumbra issues, reflecting the objective and purposes of the TCL Treaty, as required by art 31 of the Vienna Convention (general rule of treaty interpretation).

instrument does not override ‘public law’ type issues. Opinions differ on what constitutes public law for these purposes, but they generally centre on fundamental regulatory measures (trade sanctions, security, criminal law, competition law, or tort law). Moreover, the extent of the override may be open to differing views. Taken together, the private/ public law dichotomy raises borderline compliance issues. In complex TCL Treaties, *the line between private and public law is often and increasingly faint*. Close attention to a treaty’s terms and objective is required to determine if and to the extent such an override was intended.

### 2. Evidence of compliance in commercial law treaties

#### (a) Measuring and modelling

Data is necessary for measuring compliance with treaty-p. It may be ‘direct data’, that is, information on state-x’s actual compliance with treaty-y. Direct data provides a sound basis for estimating the likelihood of state-x’s future compliance, assuming no material change in relevant circumstances. Absent direct data, compliance is modelled, not measured, and the modelling uses ‘indirect data’ of various types. Indirect data may include state-x’s (i) approach to rule of law issues generally, (ii) compliance with other international obligations, and (iii) compliance signalling as seen through its implementation of treaty-p. While less informative than direct data, indirect data permits reasonable inferences about compliance with treaty-p. Annex III depicts the continuum between measuring compliance and modelling expectations of compliance and the data related to each. We turn to possible sources of data on compliance.

#### (b) Nature and source of data on compliance

Direct evidence of compliance with international law is difficult to obtain. Unlike indices on national rule of law, there is no comprehensive dataset that covers the field of international rule of law, in general, or country compliance therewith, in particular. Datasets must be manually created, a labour intensive

process requiring significant time and research capabilities. The main efforts to date have addressed international human rights law,<sup>18</sup> which presents its own set of problems (including some general concepts raising quantification issues). Some other efforts draw on existing datasets tracking ratifications of treaties, but they do not address compliance: in other words, compliance is signalled and ratification is indirect data on compliance.<sup>19</sup> A promising, but still limited, effort in this area is the OECD reporting on implementation of its anti-bribery convention.<sup>20</sup> The OECD is documenting implementation action (in our parlance, that is (i) direct data on implementational compliance, and (ii) signalling (indirect data) on other aspects of compliance).<sup>21</sup> While the scope is limited, and the data are complex, it is an important step, more so given the institutional role being played by the OECD (see also below the role of the IMF in monitoring exchange controls). Finally, another potentially useful source of data comes from treaties with dispute resolution mechanisms, which generate publicly available documents. Investment and trade treaties fall into this grouping, yet as noted below present other challenges (including the extent to which cases are settled and arbitral decisions remain confidential).

<sup>18</sup> Emile Hafner-Burton, Koyoteru Tsutsui and John Meyer, ‘International Human Rights Law and the Politics of Legitimation: Repressive States and Human Rights Treaties’ (2008) 23 *International Sociology* 115; and Oona Hathaway, ‘Why Do Countries Commit to Human Rights Treaties?’ (2007) 51 *Journal of Conflict Resolution* 588.

<sup>19</sup> Christopher Marcoux, ‘Institutional Flexibility in the Design of Multilateral Environmental Agreements’ (2009) 26 *Conflict Management and Peace Science* 209; and Philipp Bleek and Eric Lorber, ‘Security Guarantees and Allied Nuclear Proliferation’ (2014) 58 *Journal of Conflict Resolution* 429.

<sup>20</sup> *OECD Convention on Combatting Bribery of Foreign Officials in International Business Transactions*, adopted in Paris, 17 December 1997.

<sup>21</sup> OECD, ‘Country reports on the implementation of the OECD Anti-Bribery Convention’ (2014), <http://www.oecd.org/daf/anti-bribery/countryreportsontheimplementationoftheoecdanti-briberyconvention.htm>, accessed 30 September 2014.

In short, the availability of direct data on treaty compliance is a fundamental problem to be addressed. Institutions involved with the subject treaty are best positioned to take the needed steps to produce the data for further analysis by scholars, risk assessors, and transacting parties.

### (c) Problems assessing data

Compiling data, direct and indirect, is necessary but not sufficient for compliance assessment. Classic methodological items must be addressed. These include (i) sample size and distribution, (ii) the impact of changed circumstances (for example, new governments or policies), and (iii) in the case of indirect data, the validity of inferences made.

Given the issues with availability and quality of direct data, and thus with measuring international law compliance, we turn to modelling expectations of compliance in the absence of direct data, and the impact of future data on those expectations.

### 3. Expectations of compliance with commercial law treaties

#### (a) Legal and law and economics literature

Despite the absence of binding enforcement mechanisms, legal scholars expect<sup>22</sup> states to generally comply with their international obligations,<sup>23</sup> particularly those in an instrument such as treaty-p. Several theories have been propounded in the literature to support that expectation, including, even if from different starting points and with differing analyses, the

<sup>22</sup> Although some scholars use the term 'presumption', we see the terms expectation and presumption as sufficiently equivalent, and have elected to use 'expectation' throughout due to its link to the decision making process of risk assessors and transacting parties.

<sup>23</sup> Louis Henkin, *How Nations Behave* (Frederick A Praeger Publishers 1968) ('it is probably the case that almost all nations observe almost all principles of international law and almost all of their obligations almost all of the time'); and Abram Chayes and Antonia Chayes, *The New Sovereignty* (Harvard University Press 1995) ('foreign policy practitioners operate on the assumption of a general propensity of states to comply with international obligations').

reputational theory (states comply to maintain and enhance their reputation) and realist-efficient breach theory (states comply when it is efficient).<sup>24</sup> These two theories would expect state-x to comply with treaty-p, since non-compliance would have a material adverse effect on state-x's reputation and that fact, alone or in combination with other consequences, makes it more efficient to comply with treaty-p than to breach it. We may reasonably assume that such a calculation applies to state-x, where, in addition to effects on its dealings with other states in the future,<sup>25</sup> immediate and direct economic benefits are implicated. There is an additional efficiency-type view supporting compliance, based on political economy and capacity: state-x uses its limited resources and capacities to ratify and implement treaty-p rather than assessing whether each act of compliance is in its net overall interest.<sup>26</sup> Once these major policy decisions are made, treaty-p becomes the authoritative system with a strong presumption against deviation,<sup>27</sup> strengthened by supportive governmental operating procedures. Finally, law and economics scholars have argued that states adopt treaties to deal with 'international externalities'<sup>28</sup> and that the required and incentivised international cooperation presupposes compliance.<sup>29</sup> In other words, the essential reason for exercising sovereignty and entering into a treaty is the gain derived from international compliance.

From the above summary and the cited scholarship, several points follow. A compliance expectation is reasonable, all else equal, and stronger to the extent that reputational and

<sup>24</sup> Eric Posner and Alan Sykes, *Economic Foundations of International Law* (The Belknap Press 2013) 27, 127.

<sup>25</sup> Andrew Guzman, 'Reputation and International Law' (2005) 34 *Georgian Journal of International and Comparative Law* 379, 383 ('a reputation for compliance with international law is valuable because it allows states to make more credible promises to other states. This allows the state to extract greater concessions when it negotiates an international agreement').

<sup>26</sup> *Ibid* 4.

<sup>27</sup> Chayes and Chayes (n 23) 4.

<sup>28</sup> Posner and Skykes (n 24) 18.

<sup>29</sup> *Ibid* 19.

other costs of non-compliance are high. As a corollary, mechanisms and structures should be established that increase such costs. In this context, focus is on intentional non-compliance. To a degree, these compliance-supportive lines of thought are weaker in connection with unintentional non-compliance (where educational and institutional aspects are determinative).

(b) Demonstrating expectation of compliance by transacting parties

We turn to expectations of compliance inferred from economic analysis, with focus on inferences from the behaviour of transacting parties. The existence of such an expectation may be inferred from *ex post* examination of the economic benefits that resulted from state-x adopting treaty-p. Simply put: (i) if that adoption induced party-y to change its behaviour generating economic benefits in state-x, then it may be inferred that party-y expected compliance with the treaty's terms, and (ii) absent this expectation, party-y would not have changed its behaviour. Consequently, if adoption of treaty-p resulted in economic benefits for state-x, we infer the existence of an expectation of compliance.<sup>30</sup> All else equal, the greater the initial expectation of compliance by state-x, the greater the immediate economic benefits. To the extent that this expectation grows over time, so too should the economic benefits.

We apply this theory to two case studies, the first on bilateral investment treaties ('BITs'), and the second on restrictions on exchange controls under article VIII of the Articles of Agreement of the International Monetary Fund ('IMF article VIII').

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<sup>30</sup> The converse is not necessarily true, that is, a treaty may deliver no economic benefits despite a strong expectation of compliance. This will occur if a treaty is of little use to economic actors, meaning risk and costs are not substantially reduced. See Annex I.

### *Case Study I: Bilateral Investment Treaties*

**Background:** BITs set out certain terms and conditions for private investment (often called foreign direct investment, 'FDI') in one country ('host country') by nationals ('investor') of the other contract state ('home state'). They include binding obligations, *inter alia*, to ensure fair and equitable treatment and protection against expropriation by the host country without 'prompt, adequate and effective' compensation.<sup>31</sup> They often contemplate binding arbitration in which an investor is a party capable of bringing direct action against an allegedly non-compliant host country.<sup>32</sup> The main purpose of a BIT is to attract (host country) and protect (home country) the subject investments.

Absent direct data, which is not available, rates of compliance with BITs cannot be measured and must be inferred from indirect data.<sup>33</sup> A useful *upper limit* on non-compliance can be inferred by examining the number of arbitrations. By 2007, when roughly 2750 BITs were in effect, a total of 243 BIT arbitrations had been reported.<sup>34</sup> Thus, at that point, fewer than one in eleven BITs had reportedly been the subject of arbitration. If *all of these disputes* were settled in favour of the investor, and one assumes that each arbitration reflected a case of non-compliance, then the rate of *BIT compliance*

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<sup>31</sup> Developed from the so-called Hull Rule, named after Secretary of State Cordell Hull's response (1938) to the expropriation of the assets of US firms in Mexico.

<sup>32</sup> Arbitration procedures or options may be (i) set out in the BIT concluded by the home state and the host state, and/or (ii) the subject of a specific arbitration agreement between the investor and the host state. These are complex and varied, and often include an option to arbitrate through the International Centre for the Settlement of Disputes (itself created by treaty (1965 ICSID Convention), 'ICSID'), but have in common direct action by the investor.

<sup>33</sup> For our purposes, we will (over-simply) assume that an arbitral decision against the host country amounts to non-compliance by it with the BIT.

<sup>34</sup> Todd Allee and Clint Peinhardt, 'Contingent Credibility: The Impact of Investment Treaty Violations on Foreign Direct Investment' (2011) 65 *International Organization* 401.

would be 91.2%. Even if the foregoing, which by its terms is conservative (since some percentage of arbitration awards were in favour of the host country), is substantially discounted (to reflect non-compliance that was not reported or subject to arbitration<sup>35</sup>), compliance rates are significantly high (thus the reason for the proliferation of BITs).

Based on indirect data, the foregoing postulates significantly high rates of compliance. Did that correspond to an expectation of compliance; in other words, did BITs affect the behaviour of investors? As comparative pricing information (pricing for transactions before and after BITs) is not available, a reasonable proxy is whether (all else equal) BITs resulted in increased levels of FDI. The evidence available to date suggests that it did,<sup>36</sup> especially in respect to fixed-capital investments (the type of capital at the greatest risk of expropriation).<sup>37</sup> Importantly, one study<sup>38</sup> found that BITs produced large economic benefits for host countries *only until an arbitration event occurred*. Such events cause substantial outflows of foreign capital, as investors revise their expectations of future compliance downward. That downward adjustment is strong evidence of an *a priori* (pre-arbitration) expectation of compliance.

### Case Study I: IMF Article VIII

**Background:** The IMF is established by a treaty framework. Contracting states (referred to as ‘members’) may voluntarily elect not to impose exchange controls by agreeing to IMF article VIII. If they do, the obligation is binding and such imposition (without approval by the Fund) reflects non-compliance. The Executive Board

<sup>35</sup> In the case of unambiguous non-compliance, the host state may have an incentive to confidentially settle in advance.

<sup>36</sup> Andrew Kerner, ‘Why Should I Believe You? The Costs and Consequences of Bilateral Investment Treaties’ (2009) 53 *International Studies Quarterly* 73.

<sup>37</sup> Andrew Kerner and Jane Lawrence, ‘What’s the Risk? Bilateral Investment Treaties, Political Risk and Fixed Capital Accumulation’ (2012) 44 *British Journal of Political Science* 107.

<sup>38</sup> Allee and Peinhardt (n 34) 401.

of the IMF<sup>39</sup> publishes an annual list of countries with exchange controls. That list, noteworthy for its transparency, permits inferences of non-compliance with IMF article VIII.

Given the nature of exchange controls, and their link to fundamental national economic policy, often during crisis and in the context of development over time, inferred compliance rates under IMF article VIII are lower than those inferred for BITs. Yet rates are substantially higher for countries that have undertaken IMF article VIII obligations than those that have not.<sup>40</sup> Moreover, there is evidence of an expectation of compliance, as rating agencies (i) view IMF article VIII obligations as improving a country’s risk rating, and (ii) that improvement is discounted in the case of subsequent exchange controls (non-compliance).<sup>41</sup>

### (c) General Compliance Model

Taking into account the items in the foregoing sections of Part II, Annex IV depicts a model designed to assess and value<sup>42</sup> treaty-p compliance (‘general compliance model’). This model is not being proposed at this juncture,

<sup>39</sup> Which may also, but for political reasons rarely does, impose restrictions on a non-complying member’s ability to access IMF credit and funds. See IMF art XV2(a) (the Executive Board can declare members ineligible to access funds if ‘fails to fulfill any of its obligations’ under the articles).

<sup>40</sup> Beth Simmons, ‘International Law and State Behavior: Commitment and Compliance in International Monetary Affairs’ (2000) 94 *American Political Science Review* 819; and Jana von Stein, ‘Do Treaties Constrain or Screen? Selection Bias and Treaty Compliance’ (2005) 99 *American Political Science Review* 611.

<sup>41</sup> Stephan Nelson, ‘Does compliance matter? Assessing the relationship between sovereign risk and compliance with international monetary law’ (2010) 5 *Review of International Organizations* 107.

<sup>42</sup> We use the term ‘value’ (and the accompanying term ‘adjust’) conceptually, not numerically. The highest ‘value’ is the maximum point on a spectrum and the minimum value is the lowest point on that spectrum. A value is ‘adjusted’ along that spectrum. The extent of the adjustment reflects the weight of the contextual considerations or precedent, as the case may be, as outlined below.

but, rather, is set out as reflecting what we believe is the decisional and risk assessment process often followed in practice.<sup>43</sup>

We summarise the general compliance model as –

**Value-1 => Value-2 =>Value-3**, where:

**Value-1** means the threshold rule of law value,  
**Value-2** means the *a priori* compliance expectation value, and

**Value-3** means the *a posteriori* compliance expectation value

— as described below.

The main elements and mechanics of the model are as follows, which we describe, for purposes of simplicity, as a linear three-step process:

(i) **Step 1:**

State-x *starts with* a threshold rule of law value based on its approach to complying with law generally [**‘Value 1’: threshold rule of law value**];<sup>44</sup>

(ii) **Step 2:**

General and specific treaty-compliance *contextual considerations*, that is:

(a) those that incentivize state-x to comply with:

- (1) treaties in general (‘general treaty compliance incentives’),<sup>45</sup> and
- (2) treaty-p in particular (‘specific treaty compliance incentives’),<sup>46</sup> and

(b) those relating to actions taken by state-x in connection with its ratification and implementation of treaty-p, which may include state-x’s internal education on, preparation for, and technical readiness to apply, treaty-p, including public statements and positions that increase the reputational cost of its non-compliance (‘state compliance preparedness’)<sup>47</sup> –

*adjust* Value-1 to reflect the *a priori* expectation that state-x will comply with treaty-p [**‘Value-2’: a priori compliance expectation value**], that being the strength and weight of the specific expectation of compliance at any point in time that state-x will comply with treaty-p without the benefit of precedent;<sup>48</sup>

<sup>45</sup> The general treaty compliance incentive reflects the difference, if any, in incentives to comply with state-x’s (i) national law (which is not linked to a treaty), and (ii) implemented treaty-based law. The difference reflects the general obligation to comply with international law and the costs of non-complying with it. It is not treaty specific. More empirical work is needed to determine the proper adjustment value for the general treaty compliance incentive.

<sup>46</sup> The specific treaty compliance incentive reflects the difference, if any, in incentives to comply with (i) an implemental treaty in general (the above-mentioned general obligation under international law and the costs of non-complying with it), and (ii) treaty-p, in particular. See part III(2) below for discussion of the specific treaty compliance incentive in the context of CTC. More empirical work is also needed to determine the proper adjustment value for the specific treaty compliance incentive.

<sup>47</sup> This is a subjective factor, the elements and value of which are highly country and fact specific. We believe that this is an important factor.

<sup>48</sup> The maximum value of Value 2 is what is assigned assuming full treaty compliance. Value 2 would reflect the full risk reduction effected by treaty-p, if fully and accurately applied. We believe, though more empirical work is needed to confirm, that while there will be exceptions (i) for contracting states with a high Value 1 (a low rule of law risk) or a very low Value 1 (a very high rule of law risk), such Value 1 and Value 2

<sup>43</sup> We believe that the available data and research suggest that there should be a *fairly strong expectation of compliance* with well-drafted, rule-based TCL Treaties, with the following provisos. First, that expectation may not warranted in countries with a very high general rule of law risk. Secondly, we refer mainly to intentional non-compliance, but add that, for most countries without a very high general rule of law risk, implementational and unintentional non-compliance should reasonably be expected to self-correct with education and under market pressures. More empirical and analytic work is required to substantiate that belief. For application of the general compliance model to the CTC, see part III(2) below.

<sup>44</sup> There are various possible sources for this starting point value, including the indices produced by the World Justice Project (see [www.worldjusticeproject.org/rule-of-lawindex](http://www.worldjusticeproject.org/rule-of-lawindex)). Other candidates include the country risk ratings of the major international credit rating agencies. A composite index could also be developed for this specific purpose.

(iii) **Step 3:**

Actual treaty-p compliance-related experience, that is, state-x's compliance record *adjusts* Value-2 to reflect the *a posteriori* expectation that state-x will comply with treaty-p [**'Value-3': a posteriori compliance expectation value**], that being the strength and weight of the specific expectation of compliance at any point in time that state-x will comply with treaty-p with the benefit of all precedent.<sup>49</sup>

#### 4. Consequences of non-compliance with commercial law treaties

##### (a) International Law Treaty Framework in Commercial Law Treaty Context

While treaty-p, an international private law instrument, confers rights on and among transacting parties, its legal status is firmly rooted in treaty law.<sup>50</sup> That body of law, with an international public law nature, is centred on the

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will be substantially the same (in other words, in the case of the former, there is a strong expectation of compliance, and in the case of the latter, there is not, and, in either case, changes are principally made only through compliance experience (Value 3)), and (ii) for contracting states with low to mid-level Value 1 (a high to mid rule of law risk), such Value 1 and Value 2 may be substantially different based on contextual considerations (which, likewise, would be subject to changes through compliance experience (Value 3)).

<sup>49</sup> The maximum value of Value 3 is same as Value 2. Actual precedent will generally outweigh contextual considerations. It is essential that systems be put in place for the collection, assessment, and dissemination of precedent to help justify or improve the economic benefits of treaty-p based on assumed compliance with it.

<sup>50</sup> In addition to the Vienna Convention, the law of state responsibility and diplomatic protection are pertinent. They have been concisely expressed in the work of the International Law Commission of the United Nations. For our purposes, there are two key texts, the articles on Responsibility of States for Internationally Wrongful Acts, appended to GA Res 56/83, 12 December 2001 ('ILC State Responsibility'), and the draft articles on Diplomatic Protection, available with commentary in A/61/10 ('ILC Diplomatic Protection'). While neither of these sets of articles has been adopted as a treaty, they, especially the former, and are often cited as reflecting customary international law or a part of it.

rights and obligations of contracting states. In the Vienna Convention, the principal authoritative source of treaty law,<sup>51</sup> no distinction is made between public and private treaty law. As a result, treaty practice has become an important means of supplementing the Vienna Convention in the context of treaty-p, in part to take into account the transactional setting. Nevertheless, this state-centric basic framework has material implications for compliance with treaty-p.

Positively, state-x is unambiguously responsible, as a matter of international law, for its compliance obligations. Much follows from these obligations, including reputational and financial costs associated with non-performance. Negatively, the entities with enforcement-type rights against non-performing state-x under treaty-p will be the other contracting states, in our prototype state-y, not the transacting party harmed by state-x's non-compliance, in our prototype party-y. Moreover, as outlined below, the formal international law remedies available to state-y are largely ineffective (content and timing) to redress party-y's damage. Rather, such remedies provide a compliance incentive to state-x, and should be *supplemented by compliance enhancements*.

By way of general overview and summary:

(i) We start with the basis and extent of state-x's responsibility for non-compliance with treaty-p under international law. Formally, the position is clear. Such non-compliance is an 'internationally wrongful act' for which state-x has 'international responsibility'.<sup>52</sup> Non-

<sup>51</sup> As of 1 September 2014, there are 111 states that are parties to the Vienna Convention. Certain others, like the United States, nonetheless consider it authoritative, treating it as reflecting customary international law. See, e.g., U.S Department of State's statement, in 1971, that it is 'already recognized as the authoritative guide to treaty law and practice' S Exec Doc L, 92d Cong 1<sup>st</sup> Sess (1971) 1.

<sup>52</sup> There is a helpful distinction between 'primary rules', which impose obligations, and 'secondary rules', which deal with the consequences of non-performance of such obligations. See ILC YBK 1970/I, 177, 179. The inextricable link between obligation and responsibility has been made express and solidified in leading case law: *Spanish Zone of Morocco* (1924) 2 RIAA 138, *Factory at Chorzow (Jurisdiction)* (1927) PCIJ Ser A No 9 and

implementation of treaty-p caused by inaction of its executive or legislature,<sup>53</sup> or the failure by its courts<sup>54</sup> or administrative agencies to fully and accurately apply treaty-p, would be acts 'attributable' to state-x for purposes of such responsibility.<sup>55</sup> State-x cannot raise its internal law, generally or in characterisation of the action, as a defence.<sup>56</sup> Absent extreme circumstances, nor in the context of a TCL Treaty, could it legitimately assert the other broad categories of international law defences.<sup>57</sup>

(ii) In theory, that responsibility is broad and sweeping: state-x must cease and not repeat,<sup>58</sup> and make reparations (restitution and

*Chorzow Factory (Indemnity)* (1928) PCIJ Ser A 17, and *Corfu Channel* (1949) ICJ Reports 4. ILC State Responsibility, arts 1 and 2 embody these established concepts.

<sup>53</sup> ILC State Responsibility, art 4. See Arnold McNair, *Law of Treaties* (OUP 1961) 547-50. See, more particularly, James Crawford, *Brownlie's Principles of Public International Law* (8<sup>th</sup> edn, OUP 2012) 548 ('if a treaty creates a categorical obligation to incorporate certain rules in domestic law (as with uniform law treaties), failure to do so entails responsibility without the proof of actual damage'). The more general concept of 'denial of justice' also applies in this context. See *Azinian v Unites Mexican States* (1999) 5 ICSID Reports 269 and *Mondov v US* (2002) 6 ICSID Reports 192.

<sup>54</sup> ILC State Responsibility, art 4. See McNair (n 53) 346 ('a State has a right to delegate to its judicial department the application and interpretation of treaties. If, however, the courts commit errors in that task or decline to give effect to the treaty or are unable to do so because the necessary change in, or addition to, the national law has not been made, their judgments involve the State in a breach of a Treaty'). See also *US - Shrimp* WTO Doc WT/DS58/AB/R 12 October 1998 S171.

<sup>55</sup> ILC State Responsibility, art 4.

<sup>56</sup> ILC State Responsibility, arts 3 and 32. See *LeGrand* (2001) ICJ Reports 466, 472-3.

<sup>57</sup> ILC State Responsibility, arts 20-27. For example, the elements of the *force majeure* defence (art 23) generally preclude application in the TCL context, as (i) state-x's conduct, alone or in combination with other factors, is likely to be the source of the non-compliance, and (ii) state-x is likely to have assumed the risk of the underlying event. The other potential defense, necessity (art 25), must be narrowly construed. See *LG&E Energy Corp. v. Argentina* (2007) 46 ILM 40, 228.

<sup>58</sup> ILC State Responsibility, art 30. Cessation is required independent of reparations.

compensation)<sup>59</sup> for, such non-compliance.<sup>60</sup> (iii) The practical difficulties of using these international law-based rights as a means of *redressing* state-x's non-compliance with treaty-p are manifest and material. The main problems are as follows: First, governments, not corporations (legal persons) may 'invoke' state responsibility.<sup>61</sup> The former are 'subjects of international law', while the latter are not.<sup>62</sup> In other words, in our case, state-y, not party-y, is the actor on the international plane. State-y, as the 'injured state', invokes the responsibility that state-x owes to it (on account of the damage to party-y, a national of state-y).<sup>63</sup>

<sup>59</sup> ILC State Responsibility, art 31 (injury includes any damage) and 38 (interest). Compensation to be paid by the violating state equals the damage caused by it. See *Gabikovo-Nagyymaros Project* (1997) ICJ Reports 7, 81.

<sup>60</sup> ILC State Responsibility, art 28.

<sup>61</sup> ILC State Responsibility, art 42. This reflects the positivist view, which has prevailed since the nineteenth century. The invocation must be by the 'injured state', meaning (i) a state to which the obligation is owed individually, or (ii) a state which is 'specially affected' by an obligation owed to a group of states. Depending on facts and circumstances, both conjuncts may apply in the case of treaty-p.

<sup>62</sup> A subject of international law has rights and obligations thereunder. In particular, it has the capacity to assert those rights against, and be subject to claims from, other subjects of international law. States are the primary subjects of international law. There is movement in the field of human rights (and investment protection law, though the latter derives from specific international law agreements) towards the establishment of individual (and, regarding investments, corporate) international law based rights. But as such rights are circumscribed and limited, mainstream thought is that individuals and legal persons (in our case, party-y) cannot properly be called subjects of international law in the conventional sense. See generally, Janne Nijman, *The Concept of International Legal Personality* (TMC Asser Press 2004); Roland Portmann, *Legal Personality in International Law* (CUP 2010); and James Crawford, *Brownlie's Principles of Public International Law* (8<sup>th</sup> edn, OUP 2012).

<sup>63</sup> ILC Diplomatic Protection, art 9. The basic rule is that, for purposes of the foregoing, the state of nationality is the state of incorporation. There is an exception if neither substantial business activity nor management or control is in that state. The leading case is *Barcelona Traction* (1970) ICJ Reports 3, which strengthened the expectation that the state of incorporation is the state to

This concept, ‘diplomatic protection’<sup>64</sup> (given to party-y by the state in which it is incorporated, state-y) raises procedural and political problems. Matters may be otherwise to the extent that party-y concurrently has direct rights under an investment treaty,<sup>65</sup> in which case arbitration between party-y and state-x may be commenced by the former.<sup>66</sup> Secondly, as a condition to state-y invoking state-x’s responsibility, party-y must ‘exhaust all local remedies’<sup>67</sup> open to it before judicial or invoke diplomatic protection. It provided distance from the courts ruling in *Nottebohm* (1955) ICJ Reports 4 – as regards the nationality of individuals for these purposes – which applied a ‘genuine connection’ principle.

<sup>64</sup> ILC Diplomatic Protection, arts 1 and 2. The concept of diplomatic protection – a state’s invoking the international responsibility of another state in order to protect the activity of its nationals when visiting, resident, or, more to our point, doing business in foreign countries – has a long and controversial history. The legal theory (in short: while the ordering of persons and assets are a matter of domestic law and an aspect of territorial sovereignty, residence, or business abroad does not deprive one of protection of one’s state of nationality) and the relation between such theory and economic independence and related politics (which changes with time based on facts and circumstances) is far beyond the scope of this article. So too are associated concepts, such as what constitutes fair and equitable treatment, denial of justice, and expropriation in violation of international law. We simply assume non-compliance with an international obligation.

<sup>65</sup> This is fact-specific depending on the wording of the applicable investment treaty, if any, whether bilateral (‘BIT’) or multi-lateral (‘MIT’). In the case of a BIT, the transaction must (i) qualify as an ‘investment’ within the scope the treaty, and (ii) be made by an ‘investor’, as defined.

<sup>66</sup> See n 32. In addition, neither diplomatic protection by state-y nor the need to exhaust local remedies is entailed. Both the 1965 ICSID Convention and the New York Convention on the Enforceability of Foreign Arbitral Awards require the recognition and enforcement of such awards, subject to specific exceptions. See generally Zachary Douglas, *The International Law of Investment Claims* (CUP 2009).

<sup>67</sup> ILC State Responsibility, art 44(b) and ILC Diplomatic Protection, art 14. The rationale is that (i) claims are best handled by local courts, (ii) foreigners have submitted to the legal system where they are present or doing business, and (iii) international interventions, being disruptive and political, should be infrequent.

administrative authorities in state-x.<sup>68</sup> Thirdly, and in consequence of the prior points, the timing and related expenses render the remedy ineffective in practice.

(iv) In view of these practicalities, non-compliance issues are often addressed through informal procedures, which are part of treaty practice in this field. Consultations are at the centre of such procedures. Many countries have specialised government departments that actively undertake such consultations on behalf of their nationals.<sup>69</sup> While such consultations are not necessarily limited to situations where a treaty relation exists (e.g., often these departments have missions related to general trade, investment, promotion of exports, or the like), the position is substantially strengthened where it does. Treaty-p does not contain dispute resolution provisions,<sup>70</sup> whether formal (arbitration) or informal (conciliation and mediation). For future TCL treaties, that may change. In addition, practices may develop, through international organisations or otherwise, where dispute resolution is facilitated.<sup>71</sup> *In extremis*, resort could be had (by state-y) to the International Court of Justice

<sup>68</sup> ILC Diplomatic Protection, art 15. These are the exceptions to this rule: local remedies must be reasonably available, effective, and not subject to undue delay (or may be waived by the host state). The standard is that an effective remedy must be ‘a reasonable possibility’. See *Norwegian Loans* (1957) ICJ Reports 9. Yet international jurisprudence had been cautious to find no effective local remedy. As a result, the matter would be subject to extensive and costly litigation.

<sup>69</sup> The exemplar is the US Department of Commerce. Compliance attaches staff its US Commercial Services, with offices in most US Embassies around the world. See [http://tcc.export.gov/compliance\\_attaches/index.asp](http://tcc.export.gov/compliance_attaches/index.asp), accessed on 30 September 2014. More broadly, the US Department of Commerce, through its International Trade Association, runs the ‘ITA Trade Agreements Compliance Program’ as the framework for monitoring the operation of over 250 industrial trade agreements.

<sup>70</sup> As to disputes between the contracting states regarding their compliance with treaty-p. That is to be distinguished from choice of forum clauses for disputes between the transacting parties, as seen, for example, in CTC and the transport of goods conventions.

<sup>71</sup> See discussion below as to how such might serve as a compliance enhancement.

(judicial settlement),<sup>72</sup> which could also give advisory opinions.<sup>73</sup>

(b) National Law Remedies

Independent of the above-noted exhaustion of local remedies is this stand-alone question: does party-y have rights under the national law of state-x in respect of the latter's non-compliance with treaty-p. The related set of sub-questions is country-specific,<sup>74</sup> including the following:

- (i) Does the law of state-x give remedies to private parties for violations by the government of its national laws (which intend to confer rights on private parties), and, if so, what remedies (specific performance and/or damages) and on what conditions, if any?<sup>75</sup>
- (ii) Are there sovereign immunity type impediments that would preclude or qualify any such remedies, and, if so, is there any means of overcoming them, taking into account the capacity in which the government is acting

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<sup>72</sup> The ICJ has jurisdiction only between states and on the basis of consent. The Statute of the International Court of Justice ("ICJ Statute"), arts 34(1) and 36. That consent can take several forms, including a clause in a treaty, an optional protocol or a related special instrument (*compromise*) linked to the underlying treaty, or reciprocal declarations under Article 36 of the ICJ Statute.

<sup>73</sup> ICJ Statute, art 65(1).

<sup>74</sup> In the EU context, new legal avenues are developing. For example, while the 'direct effects doctrine' does not allow EU law to create national causes of action, it does allow individual litigants to raise EU law issues in national courts. Ralph Folsom, *Principles of European Union Law* (4<sup>th</sup> edn, West Academic Publishing 2014) 78-79, 85.

<sup>75</sup> Most scholarship in this area has focused on human rights treaties, where the question of whether such a remedy exists is dependent on the state in question and the underlying treaty. See Chittharanjan Amerasinghe, *Local Remedies in International Law* (2nd edn, CUP 2004); Beth Stephens, 'Translating Filártiga: A Comparative and International Law Analysis of Domestic Remedies for International Human Rights Violations' (2002) 27 *Yale Journal of International Law* 2; William Castro, 'The New Federal Common Law of Tort Remedies for Violations of International Law' (2006) 37 *Rutgers Law Journal* 635; and Kenneth Randall, 'Universal Jurisdiction Under International Law' (1987) 66 *Texas Law Review* 785.

(law-maker and law enforcer, not a contracting party which could waive rights)?

(iii) Does it matter if the non-compliance is attributable to non-implementation, meaning that the terms of treaty-p do not constitute prevailing national law in the first place?

(c) Transactional and Economic Consequences

The transactional and economic consequences of state-x's non-compliance with treaty-p are more impactful than the above-noted international and legal consequences. **Transactional consequences**, the inverse of microeconomic benefits (as defined in footnote 2 above), means adverse effects on transactions, current and future. **Economic consequences**, the inverse of macroeconomic benefits and developmental benefits (as defined in footnote 2 above), means adverse effects on the national economy, including employment, trade, and development.

(i) As regards transactional consequences, the following can be safely stated. First, non-compliance by state-x may impact existing contracts involving its nationals. If one party has been allocated this risk, non-compliance may constitute a contractual default, whether or not it is deemed a change in law. It may also trigger application of further assurance or other restructuring clauses. At a minimum, such non-compliance will adversely impact and increase transaction costs (broadly defined). Secondly, as depicted in the general compliance model above, compliance or non-compliance will determine the '*a posteriori* compliance expectation value'. An initial case of non-compliance should be expected substantially to reduce that value.<sup>76</sup> The greater the proportion of legal to overall transactional risk, the more adverse the consequences. That would be seen in reduced transaction volumes and higher transaction costs, including on core terms such as pricing (in sales transactions) and margins and rates (in financing transactions).

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<sup>76</sup> Unless there was a very low *a priori* compliance expectation value. Conversely, a case of compliance would substantially increase the *a posteriori* compliance expectation value, unless there is already a high *a priori* compliance expectation value.

(ii) Economic consequences will follow directly from transactional consequences. The magnitude will be context and country specific, taking into account the volumes involved. The variables will depend on the relationship between the subject transaction type and related economic and developmental activity. The closer that relation, the greater the adverse multiplying effect, including on (1) consumers costs, reduced employment, reduced levels of trade, investment, or liquidity, and less efficient allocation of governmental resources, and, in turn, (2) broader disadvantages that impose societal costs, for example, on weakened physical infrastructure, weakened trading systems, and increased external debt.

(iii) Evidence from the above-described BIT and IMF case studies indicate that the losses were neither hypothetical nor trivial. For example, countries that did not comply with their obligations under IMF article VIII<sup>77</sup> experienced credit rating downgrades to the level that existed before treaty undertaking, thereby restricting the availability of credit or increasing its cost.<sup>78</sup> Countries subject to BIT-related arbitration<sup>79</sup> experienced a loss of 3.6–5.7% of annual FDI *per dispute*.<sup>80</sup> These costs can reasonably be assumed to have spread throughout the economies of the affected countries. FDI has been linked to poverty alleviation<sup>81</sup> and growth generally<sup>82</sup>, and the central role of finance in economic growth and development<sup>83</sup> has been well documented.<sup>84</sup>

<sup>77</sup> Introduced in Part II(3) above.

<sup>78</sup> Figures from Nelson (n 31).

<sup>79</sup> Introduced in Part II(2)(a) above.

<sup>80</sup> Allee and Peinhardt (n 34) 401.

<sup>81</sup> Michael Klein et al, 'Foreign Direct Investment and Poverty Reduction', *World Bank Policy Research Working Paper No. 2613* (2001) (on file with the author).

<sup>82</sup> Eduardo Borensztein et al, 'How Does Foreign Direct Investment Affect Growth?' (1998) 45 *Journal of International Economics* 115.

<sup>83</sup> Giovanni Ferri et al, 'The role of rating agency assessments in less developed countries: Impact of the proposed Basel guidelines' (2001) 25 *Journal of Banking and Finance* 115; and Eduardo Borensztein et

### 5. Enhancements to compliance with commercial law treaties

We turn to practices and elements designed to increase compliance, and the expectation of compliance with, treaty-p. Each relates to and seeks to address one or more potential causes of non-compliance discussed above. Save for item (b), they aim to make non-compliance more objective, transparent, and costly.

(a) Objectively clear and precise rules, rather than standards

Clear and precise rules in treaty-p are a condition to an economically impactful expectation of compliance. Bright lines ('act within x days', not 'within a reasonable period') and declarative results-defining rules ('jurisdiction is with x', not 'jurisdiction is determined under rules of private international law') are preferred. Generalised standards neither reduce risk nor provide clarity on compliance: party-y must know exactly what state-x is undertaking. Borderline cases should be reduced to the extent possible. Gaps should be limited and filled by general principles tied to detailed preamble clauses.<sup>85</sup> TCL Treaties have become more comprehensive and rule oriented, and that process should continue. It tracks a parallel development in the BIT context, where such treaties increasingly address points in considerable detail.<sup>86</sup>

al, Sovereign ceilings light? 'The impact of sovereign ratings on corporate ratings' (2013) 37 *Journal of Banking and Finance* 4014.

<sup>84</sup> Thorsten Beck et al, 'Finance and the sources of growth' (2000) 58 *Journal of Financial Economics* 261.

<sup>85</sup> This is similar to the concept of a *complete contract* in the economics literature. *Incomplete contracts*, that is, ones those that do not provide sufficient clarity, result in significant economic inefficiencies. See Oliver Hart and John Moore, 'Incomplete Contracts and Renegotiation' (1988) 56 *Econometrica* 755.

<sup>86</sup> Mark Manger and Clint Peinhardt, 'Learning and Diffusion in International Investment Agreements' (2014) (working paper, on file with the author).

(b) Educational and practical compliance-related information and resources

The principal means of addressing unintentional non-compliance are, first, the development of detailed, multi-lingual and otherwise comprehensible, and readily available education materials (essentially, compliance type manuals), and, secondly, increasing the resources, to be used in a targeted and effective manner, to enhance the skill and capacity of institutions to efficiently comply with treaty-p.<sup>87</sup> The trend of sponsoring international organisations preparing official commentaries and guides, and disseminating compliance related information, should be strongly encouraged. By extension, databases of legal and administrative decisions should be developed. In addition to providing compliance incentives and information (as discussed in the next section), they facilitate uniform and internationally oriented interpretation, as required by treaty-p.

(c) Transparency and related reporting systems

Reporting systems and other methods of making compliance information transparent and readily available are essential. That applies to all forms of non-compliance: implementational, unintentional, and intentional. There are two independent but mutual reinforcing reasons for that. First, there is substantial evidence that transparency increases the cost of non-compliance, thereby (under both the reputational and realist/efficient breach schools of thought discussed above) increasing compliance and the expectation of compliance.<sup>88</sup> While that evidence extends to the *mere existence of a monitoring and reporting system*, whether actually reported in or not,<sup>89</sup>

<sup>87</sup> Chia-yi Lee & Noel Johnston, 'Improving Reputation BIT by BIT: Bilateral Investment Treaties, Domestic Institutions, and Foreign Accountability' (2012) (working paper, on file with the author).

<sup>88</sup> Edward Weisband, 'Discursive Multilateralism: Global Benchmarks, Shame, and Learning in the ILO Labor Standards Monitoring Regime' (2000) *International Studies Quarterly* 643.

<sup>89</sup> Judith Kelly and Beth Simmons, 'Politics by Numbers: Indicators as Social Pressure in International

the more active and robust the system, the more compliance enhancing it is. The further dissemination of reported information (in the general media and trade journals) has substantial multiplying effects.

Secondly, in connection with its transactional decision-making, party-y must have efficient access to compliance information about state-x. If that is not the case, party-y will either (i) incur greater information-gathering and transaction costs, reducing the economic attractiveness of the transaction, or (ii) assume that state-x's general rule of law value applies equally to treaty-p (in other words, adverse modelling rather than more favourable measurement techniques will be employed). That modelling penalises (complying states) with a weaker reputation on rule of law generally. It prevents them from benefitting, to the maximum extent possible, from a treaty with which they are complying. That is a disincentive to comply, and its inverse is an incentive to comply.

(d) Quantifying the consequences, economic and reputational

Identifying and quantifying the cost of non-compliance provides a compliance incentive.<sup>90</sup> That is not an easy task, as it requires data, and, in practice, time. It is therefore difficult in a new treaty system. Moreover, relevant information (financial) may be confidential and/or diffuse. Other information (reputation) has elements of subjectivity, though there are useful proxies. Such quantification could reduce all categories of non-compliance.

Relations' *American Journal of Political Science* (Forthcoming) (copy on file with the author). More precisely, the authors, building on the 'Hawthorne effect' (individual may re-arrange their priorities to meet external expectations when they are aware of being observed), note that 'even the *anticipation* of publicity and negative domestic reactions could in some cases prompt preemptive policy review by government officials'.

<sup>90</sup> Nathan Jensen et al, 'Crisis and Contract Breach: The Domestic and International Determinants of Expropriation' (2014) (working paper, on file with the author).

(e) Legal effects, such as contemplated dispute resolution procedures

In part II(4)(a) we outlined the limited effectiveness of customary international law remedies to prevent non-compliance by state-x or to redress party-y for loss in consequences thereof, though their existence and associated diplomatic practices provide compliance incentives. Yet no TCL Treaty has ventured beyond such customary international law. Lessons from the BIT context, however, are again instructive. The binding arbitration contemplated thereby has been found to increase FDI inflows, implying a stronger expectation of compliance.<sup>91</sup> Dispute resolution provisions signal greater compliance intent and increase the cost of non-compliance.<sup>92</sup>

It follows that, all else equal, if treaty-p imposes binding legal consequences for non-compliance (such as arbitration initiated by party-y), compliance is more likely. A variant would link non-compliance of treaty-p to the applicable BIT between party-y's home country and the non-complying state (assuming they are treaty-p contracting states). A second variant could have all or some contracting states to treaty-p agree to a supplemental instrument that contemplates arbitration or other dispute resolution. Whether new ground can be broken in the TCL Treaty context, requiring hitherto unseen political will, cannot be assessed.<sup>93</sup>

<sup>91</sup> Tim Büthe and Helen Milner, 'Foreign Direct Investment and Institutional Diversity in Trade Agreements: Credibility, Commitment, and Economic Flows to the Developing World, 1971-2007' (2014) 66 *World Politics* 88.

<sup>92</sup> See Michael Tomz, 'Reputation and the Effects of International Law on Preferences and Beliefs' (2008) (working paper, on file with the author).

<sup>93</sup> In contrast to BITs, a major impediment is the multilateral nature of treaty-p. While the WTO example counters the proposition that contemplated dispute resolution cannot be agreed multilaterally, the time and cost, including political obstacles, domestic and international, would be substantial.

### III. Application of the treaty compliance law framework to the Cape Town Convention

We apply the proposed Treaty Compliance Framework to the Cape Town Convention. We presuppose all terminology in, and the context of Part II, permitting maximum concision.

#### 1. *Compliance with the Cape Town Convention – the analytics and evidence*

Combining the key elements in Part II(1) and (2), what can reasonably be said about the analytics and evidence of compliance with the CTC since its entry into force in early 2006? In its over fifty contracting states, does the CTC legally apply, and has it been fully and accurately applied, to all matters within its scope?

(a) Comments on the main sources of non-compliance: implementational compliance / non-compliance, unintentional non-compliance, and intentional non-compliance

(i) In contrast to the other categories, there is substantial publically available data on **implementational compliance / non-compliance**. At present, this is the only category that can be measured systematically and with a reasonable degree of objectivity. We have previously addressed this topic<sup>94</sup> – which is the subject of an on-going project being undertaken by the Aviation Working Group ('AWG')<sup>95</sup> – and, thus, we merely re-cap for present purposes. An important note and disclaimer: all references herein to specific contract states are solely for purposes of illustration. They are far from comprehensive. For more general information, see the summary of national implementation,

<sup>94</sup> Wool and Jonovic (n 5) 65.

<sup>95</sup> The continuous results of the project are set out in updated versions of the 'summary of national implementation'. It is available at [www.awg.aero](http://www.awg.aero). The document (currently dated October 2013) is scheduled for update in October 2014. In addition, the Aviation Working Group is currently working on two extensions to that document, one on non-consensual liens and interests, the other on de-registration on export. In due course, these will be included in the updated versions of the main project document.

which is subject to its own comprehensive disclaimer incorporated by reference herein.

The overall situation on implementational compliance / non-compliance has been varied, though the trajectory is broadly positive. On the one hand, there have been few problems in concluding that the CTC has the force of law in contracting states. Where present, the problem has generally been addressed by post-ratification<sup>96</sup> corrective action (e.g., Brazil and Kazakhstan). While force of law needs to be confirmed on a country-by-country basis, it has not been a problem area. On the other hand, that is not the case for the primacy of the CTC over conflicting law, where there have been significant problems in a substantial minority of contracting states. As the 'CTC discount' under the 'ASU'<sup>97</sup> is conditioned on effective implementation,<sup>98</sup> and private markets apply similar principles, market dynamics are encouraging the correction of these problems.

The core problem has been insufficient implementation action, mainly the need in such contracting states for (1) general legislation or other legal activity to ensure CTC primacy ('general primacy legislation'), or (2) specific regulations, directives, or the like to apply the CTC provisions on de-registration and export in general, and the acceptance and enforcement of irrevocable de-registration and export

<sup>96</sup>We use the term 'ratification' to include 'accession', and 'post-ratification' to mean following the entry into force of the CTC in the ratifying contract state, not the date when the instruments were deposited with UNIDROIT, the legal depositary.

<sup>97</sup>The Aircraft Sector Understanding to the OECD Arrangement on Officially Supported Export Credits, September 2012, as available at [www.oecd.org](http://www.oecd.org).

<sup>98</sup> That discount to borrowers based in countries on an eligibility list, of up to ten percent (10%) of the otherwise applicable fee, requires that the CTC be 'appropriately translated into national law'. That ambiguous standard, however, is clarified and strengthened by art 40 of Appendix II to the ASU, which requires, as a condition to be added to the list, the completion of a questionnaire in the form of Annex 2 to that Appendix. That questionnaire, at question 1.2, asks whether the CTC, as so translated into national law, 'overrule[s] or [has] priority over any conflicting national law, regulation, order, judicial precedent, or regulatory practice'.

authorizations in particular ('IDERAs'),<sup>99</sup> in place of otherwise applicable rules ('IDERA regulations'). In the case of needed general primacy legislation,<sup>100</sup> some countries have taken post-ratification corrective action (e.g., Indonesia (clarification), Kenya, and Nigeria), while others still need to (e.g., India and South Africa). In the case of needed IDERA regulations, the picture is complex and evolving. In some such cases, IDERA regulations are required as a matter of law. In others, they are needed for practical reasons. We will address this under the heading of unintentional non-compliance.

(ii) Publicly available data bearing on whether CTC has been fully and accurately applied is limited, for two reasons. First, the CTC is a relatively new treaty system with few reported enforcement actions. Secondly, there has been no vehicle for collecting and disseminating such data. The latter is a weakness in the CTC system, exacerbated by the fact that much CTC-related action is *administrative, not judicial*. The lack of data limits the ability of transacting parties to rely on the CTC, and for airlines to benefit from the CTC in contracting states in which there are rule of law risk concerns, real or perceived. The Cape Town Convention academic project ('CTCAP')<sup>101</sup> is seeking to address this weakness by establishing databases that permit reporting on (1) judicial activity, and, importantly (2) administrative and other non-judicial activity ('compliance-related database'). This initiative is discussed below.

<sup>99</sup> Article IX(1)(basic rules) and IX(5) and XIII (IDERA rules) of the Aircraft Protocol. Also relevant on timing issues are Article X(6) (in the context of advance relief) and XI(8) (alt A) (in the context of insolvency).

<sup>100</sup> Most countries that needed general primacy legislation (e.g. Canada, Malaysia, Norway, and Malta) promulgated it prior to ratification. Many contracting states (e.g. China, Mexico, Russia, and the US) do not need general primacy legislation, as treaties are the highest legal norm in their legal systems.

<sup>101</sup> The CTCAP is a joint undertaking by the University of Oxford Faculty of Law and the University of Washington School of Law. Certain project segments are conducted under the joint auspices of UNIDROIT. The CTCAP cooperates with ICAO, among others. AWG is the founding sponsor of the CTCAP.

(iii) As a result of above noted data issues, information regarding application of the CTC is anecdotal and not necessarily fully accurate. There are few reported cases, and those that exist neither address core CTC issues (save whether registered non-consensual rights and interests ('NCRIs') which lack a legal basis should be discharged from the international registry<sup>102</sup>) nor are subject to reasoned opinions. There is also some public confusion stemming from an inaccurate expectation that the CTC applies in contracting states to pre-existing transactions.<sup>103</sup>

(iv) What can be said with accuracy is that, to date, the main (non-implementation) compliance questions<sup>104</sup> have centred, primarily, on the recordation and enforcement of IDERAs, and, secondarily and still more limitedly, on governmentally-asserted NCRIs or rights of detention. To our knowledge, there have been no CTC reported actions involving attempts at physical repossession or sale or the treatment of CTC rights in insolvency proceedings.

As regards IDERAs, while there have been effective de-registrations and exports as contemplated by CTC (e.g., in the UAE, Jordan, and Ireland) there have been *limited instances of unintentional non-compliance*, mainly related to a lack of technical knowledge or the absence of IDERA regulations.<sup>105</sup> Work with

<sup>102</sup> See *PNC Equipment Finance LLC v. Aviareto Limited and Link LLC*, Unreported, Irish High Court (Commercial Division) 19 December 2012 and *Tiansfin-M v Steam Aero Investments S.A. and Aviareto Limited*, Unreported, Irish High Court (Commercial Division) 12 April 2013.

<sup>103</sup> See *Corporate Funding Company LLC v Union of India & Ors*, WP (C) 792/2012 (de-registration and export issues in a pre-existing transaction subject to an amendment post-ratification).

<sup>104</sup> We are not mentioning names of the few contracting states in which such issues have arisen, as this article seeks to establish a general framework. It is not a report. See below for discussion of a reporting database.

<sup>105</sup> IDERA regulations have been the main source of unintentional non-compliance to date for two reasons: (i) they are needed to permit civil aviation and other governmental officials to understand and discharge the

governmental officials (and some subsequent action) has indicated or demonstrated their desire to act in accordance with the CTC. To date, most issues relate to recording, not enforcing, IDERAs. As the latter effects a core CTC remedy, the relevant contracting states have a limited window to perfect their systems. AWG is publishing a model form of IDERA regulation to assist in that regard.

The few fact patterns pertaining to the assertion of governmental NCRIs or rights of detention do not lend themselves to general statements about whether compliance issues have arisen, and, if so, whether they are in the category of unintentional or intentional. They have related to complex facts involving contracting states and non-contracting states (Malta and Italy) and pre-existing transactions (India). AWG and its legal advisory panel<sup>106</sup> are analysing these instances, and will be reporting on them, and other CTC activity, in the latter's periodic publications on 'CTC legal activity reporting'.

#### (b) CTC borderline cases

(i) The CTC, supported by Resolution No. 5 adopted at its diplomatic conference, minimises compliance issues arising from borderline cases. The former is a clear, rule-oriented, and fairly comprehensive text (without

IDERA related provisions of the Aircraft Protocol, but have not been issued, or (ii) they have been issued, but do not comply with the CTC requirements (including inconsistency with CTC) or have been interpreted in a manner which is non-compliant. Included in the latter are regulations that (a) do not include the needed timetables, as set out in Articles X(6) or XI(b)(alt A) of the Aircraft Protocol, (b) do not require that all treaty-compliant IDERAs be recorded or that impose procedures which restrict the right in any material sense, or (c) that do not contemplate a 'purely documentary' process (see Official Commentary para 3.36).

<sup>106</sup> The AWG's legal advisory panel is made up of leading international aviation lawyers, who are listed at [www.awg.aero](http://www.awg.aero). The AWG has also established, and is establishing, national and regional 'contact groups' around the world *inter alia* to provide compliance-related data in their countries and regions and assess that data. The national groups report to the legal advisory panel, under AWG's supervision.

affecting the contemplated and important, but circumscribed, role of national law), at least on core legal points. The latter, specifically designed to aid those working with the text, authorised the preparation of the invaluable Official Commentary on the CTC by Professor Sir Roy Goode ('Official Commentary'). The Official Commentary, now in its Third Edition, provides authoritative guidance on most borderline issues.<sup>107</sup> With the personal endorsement of Professor Goode, the CTCAP issues 'annotations' to the Official Commentary where the latter does not deal or deal fully with items as they arise in the future.

(ii) The CTC is generally closed-textured, and contains the most predictability-enhancing version of the standard gap-filling clause found in TCL Treaties. That clause (1) replaces references to good faith interpretation with one seeking to promote predictability, (2) expressly refers to interpretation in light of the purposes set out in the preamble, which are detailed and commercially-oriented, and (3) requires reference to general principle (based on the foregoing) prior to the application of national law. These provisions, together with the *sui generis* concepts in the CTC, create an exceptionally large penumbra or periphery surrounding the core CTC principles. That space, for gap-filling purposes, is to be filled by overarching general principles which otherwise could give rise to borderline compliance issues. These include (1) a strong presumption on the enforceability of contractual provisions where the CTC is silent, (2) implying terms, when needed, to enhance transactional predictability based on international best practices in asset-based financing and leasing and to preserve the *sui generis* nature of the treaty concepts, and

<sup>107</sup> For example, the Official Commentary, at para 2.9(1), provides a dividing line between public law and private law rights regulated by the CTC. Among other key points, it preserves public law rules (mainly in the IDERA context) on economic sanctions, while restricting the ability of the authorities of a contracting state to assert (against a registered international interest) a NCRI or right of detention to secure import customs fees unless covered by a permitted declaration under Articles 39 or 40 of the Convention.

(3) preventing imposition of conditions which restrict CTC rights.<sup>108</sup>

(iii) While experience to date has not presented many borderline issues, and the few examples that arose were (or are being) positively addressed,<sup>109</sup> pro-active educational efforts and general vigilance are required to ensure that a comprehensive CTC-compliant approach is taken in all CTC governmental activity. Only that will prevent incremental or unintentional borderline compliance cases.

## 2. *Expectations and modelling of compliance with the Cape Town Convention*

### (a) General comments on expectations

Before we apply the general compliance model to the CTC, let us of summarise key points relevant for that purpose.

First, direct data is not available, save for assessing implementational non-compliance, and that is varied and vectoring positively.

Secondly, the CTC is a treaty for which non-compliance costs, financial and reputational, are relatively high. The sources of such high costs are linked to (i) the loss of eligibility for the CTC discount, (ii) increased costs in, and, in some cases, loss of, market-based financing options (and the multiplying effect thereof) -- which would be swiftly realised given the efficient and focused transmission of global information in the concentrated aviation finance sector, (iii) general reputational costs of non-compliance with financial and investment treaty law, and inferences that may be drawn therefrom, and (iv) general reputational costs of non-compliance with aviation treaty law,

<sup>108</sup> Taken from Wool and Jonovic (n 5) 65, which contains a fuller treatment.

<sup>109</sup> Three examples are of note. First, Kenya instituted, then rightly withdrew, costly provisions in connection with IDERAs. Secondly, Turkish authorities are clarifying that impermissible mandatory grace periods, applicable pre-CTC, are not required (to receive favorable tax treatment) in post-CTC financial leases, as that would effectively override Article 11(1) of the Convention. Thirdly, efforts are being made with the Indian authorities to prevent non-compliant airline and other consents being required in connection with the exercise of IDERA rights.

with its strong culture of compliance (based on the safety-oriented focus and high standing of ICAO, the international regulator), and inferences that may be drawn therefrom.

Thirdly, as discussed in Part III(4), such non-compliance costs would be further increased (i) by a more timely, interactive, and transparent process under the ASU to lose, and, if lost, re-acquire eligibility for the CTC discount, (ii) active use and searching of the compliance-related databases, in particular, the one relating to administrative and other non-judicial activity (which would create compliance-related data), and (iii) by more developed, if informal, diplomatic practices in the case of signs of or inchoate non-compliance.

Fourthly, various systems are being put into place, and others are to follow, providing more information designed to minimise the risk, severity, and length of unintentional non-compliance.

(b) Application of general compliance model to the Cape Town Convention

(i) There is nothing CTC-specific to add to **Value 1, the threshold rule of law value**. It would be determined against standards outlined in footnote 44.

(ii) In the case of **Value 2, the a priori compliance expectation value**:

(1) There is nothing CTC-specific about the 'general treaty compliance incentive'. The delta between it and Value 1 would be determined as outlined in footnote 45, including on the basis of further empirical work to determine the proper adjustment;

(2) For the reasons outlined in Part III(2) (a) immediately above, the 'specific treaty compliance incentives' for CTC are substantial (and more substantial with the actions noted therein and set out in Part III(4) below), itself justifying a substantial delta between Value 1 and Value 2 in all cases other than where the former is high (as there is an upper limit)<sup>110</sup>

<sup>110</sup> In other words, in such cases the expectation of compliance absent precedent is high until proved otherwise. A clear example of that, in the CTC context,

or extremely low (where the practical effect of such incentives would (rightly or wrongly) be sharply discounted, absent experience / precedent; and

(3) The 'state compliance preparedness' adjustment is subjective and contracting state specific, as noted in footnote 47.<sup>111</sup> A contracting state should make efforts to increase confidence in its ability and willingness to fully and accurately apply the CTC to all matters within its scope. We encourage further internationalised efforts on the contours of such confidence-building measures.

(iii) In the case of **Value 3, the a posteriori compliance expectation value**: contracting states, including those with a very low Value 1 (and Value 2), can realise a substantial upward adjustment based on actual experience/precedent, particularly where such establishes a pattern and rebuts presumptions underlying that low Value 1. However, the existence and active use of the compliance-related databases is likely a condition to such adjustment, or, at a minimum, reduces the costs of information-gathering needed to reach the same conclusion by other means.

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was the rating given to the securities in the recent Air Canada transaction. See *SP rating report: Air Canada 2013-1 Pass Through Certificates Rated 'A-' (sf)(Class A) and Preliminary 'BB' (sf)(Class B), April 24, 2013* (the report 'assumes that Canadian courts will interpret that statutory provisions that implement the Cape Town Convention in a manner that will give effect to the protections afforded by the Cape Town Convention and its related protocol'). Compare that with the transaction referred to in footnote 111, in which Moody's stated that there was 'no case history from which to infer future outcomes'.

<sup>111</sup> An indication, in the CTC context, was seen in an early capital market transaction, which took the declarations into account, including as an aspect of signaling. See *Moody's rating report: DNA Alpha Limited Series 2013-1 Enhanced Equipment Trust Certificates, June 25 2013* (the report states that Moody's 'considered that the UAE adopted the Cape Town Convention in a manner that was intended to be favorable to creditors as it adopted Alternative A, the use of IDERA and choice of law').

3. *Consequences of non-compliance with the Cape Town Convention*

The financial and reputational consequences of material non-compliance of the CTC are those set out in Part III(2)(a). The magnitude and timing of such consequences (loss of the CTC discount, assuming it was available; more expensive and possibly restricted sources of private finance; and reputational costs as a state that has violated international law in the finance, investment, and aviation treaty contexts) will be fact-specific, including with respect to corrective action taken and the credibility of undertakings not to repeat any such non-compliance. Absent extreme circumstances, it is not expected that such non-compliance would give rise to formal international law remedies (given their impractical nature in this context), but in many cases would activate informal diplomatic consultations.

4. *Enhancements to compliance with the Cape Town Convention*

We refrain from making any sweeping suggestions, such as increasing legal consequences, in the case of non-compliance, for example, by expressly linking the CTC to BITs or suggesting supplemental legal instruments. In our view, such action is neither necessary (given favourable compliance activity to date and expectations of compliance) nor realistic (given the time, cost, and complexity of developing and securing agreement to the necessary instruments). Though we see the surface plausibility of a connection to BITs if needed at some point in the future.

Rather, in addition to continuing of the steady work underway on educational and institutional items designed to reduce the risk, severity, and length of unintentional non-compliance, we suggest the following two enhancements, which would meaningfully increase CTC compliance incentives:

(a) Improved process for loss and re-acquisition of CTC discount eligibility

The OECD deserves much credit for the thoughtful and forward-looking manner in which it developed and documented the requirements for the CTC discount. As an international organisation, it properly presumed compliance (assuming effective implementation), not differentiating between states. Its approach substantially incentivized ratification (with the risk-reducing set of declarations) and effective implementation and compliance. Its action advanced its general objective of attracting and aligning with markets.

The prospect of losing eligibility for the CTC discount is a major compliance incentive, as that action would have substantial adverse financial and reputational costs, as noted above. The strength of that incentive is based on the efficacy of the ASU mechanism to lose (and re-acquire) that eligibility, and a robust approach should be timely, interactive, and transparent. The approach taken in the ASU can be materially improved to achieve that objective.<sup>112</sup>

(b) Active use and searching of compliance-related databases

In line with (i) the general objective of legal transparency, and (ii) the advancement of rule of law principles generally, the development and active use and searching of compliance-

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<sup>112</sup> The current approach, set out in by art 42 (regarding loss of eligibility) and 43 (regarding re-acquisition of eligibility) of Appendix II to the ASU, correctly and concisely focuses on actions that are 'inconsistent with' or 'required by' the CTC. But the *process* is dependent on a proposal by an ASU participant with supporting materials, and to date has not been employed. As discussed in this article, compliance questions may be complex and/or data dependent, though the use of compliance-related databases will partially address the latter. An arrangement whereby more expertise is provided, and importantly potential non-compliant states are actively and constructively engaged in real time, would further improve the prospects of compliance. Such a process might permit the immediate correction of the non-compliance, thereby avoiding the loss of eligibility.

related databases are fundamental. As noted above, evidence shows that the *very existence* of transparent systems enhances compliance, and their active use provides further enhancements. The databases permit, and perhaps only the databases permit, certain contracting states following evidence of their compliance to realise the maximum benefits from the CTC. In particular, they aid developing jurisdictions, and, in that light, may be seen as important means of legal and technical assistance and support.<sup>113</sup>

With these objectives in mind, the CTCAP repository contains compliance-related databases, which contemplate reporting on (i) judicial activity, and, importantly (ii) administrative and other non-judicial activity. The former is a traditional database, seen in the context of a number of other treaty systems. The latter is as novel and innovative as it is important: in the context of CTC, most legal action is administrative and non-judicial, and in some contracting states such action is not in written form and/or publicly available. The approach is unique in *creating data* through a transparent process giving all interested parties the ability to report and comment on content. The contemplated reporting and commenting form is set out as Annex V. Like the CTC, it may become the model for future efforts in related fields. We encourage the full support, in the spirit of the above-noted Resolution No. 4 of the diplomatic conference, of all governments, international organisations, and private parties for the contemplated use of that administrative database.

#### IV. Concluding comments

Compliance with TCL Treaties in general, and the CTC in particular, has not received the attention it deserves given the central role of state compliance in ensuring intended economic benefits. This article attempts to

rapidly accelerate that process by setting out a broad compliance framework, including a general compliance model, and applying it to CTC. It also makes concrete suggestions to enhance compliance, generally and specifically.

Many areas are identified for further research. This work by its nature is interdisciplinary, resting at the intersection of law, economics, and intentional relations. We hope that future work will be undertaken in that manner, providing synthesized results that clarify action needed to maximize compliance expectations, and accordingly economic benefits.

<sup>113</sup> Which is in the spirit of Resolution No. 4 adopted at the diplomatic conference which calls on all negotiating states, international organisations, and private parties to ‘assist developing negotiating states in any appropriate way... so as to allow them to benefit from’ the CTC.

**Annex I**

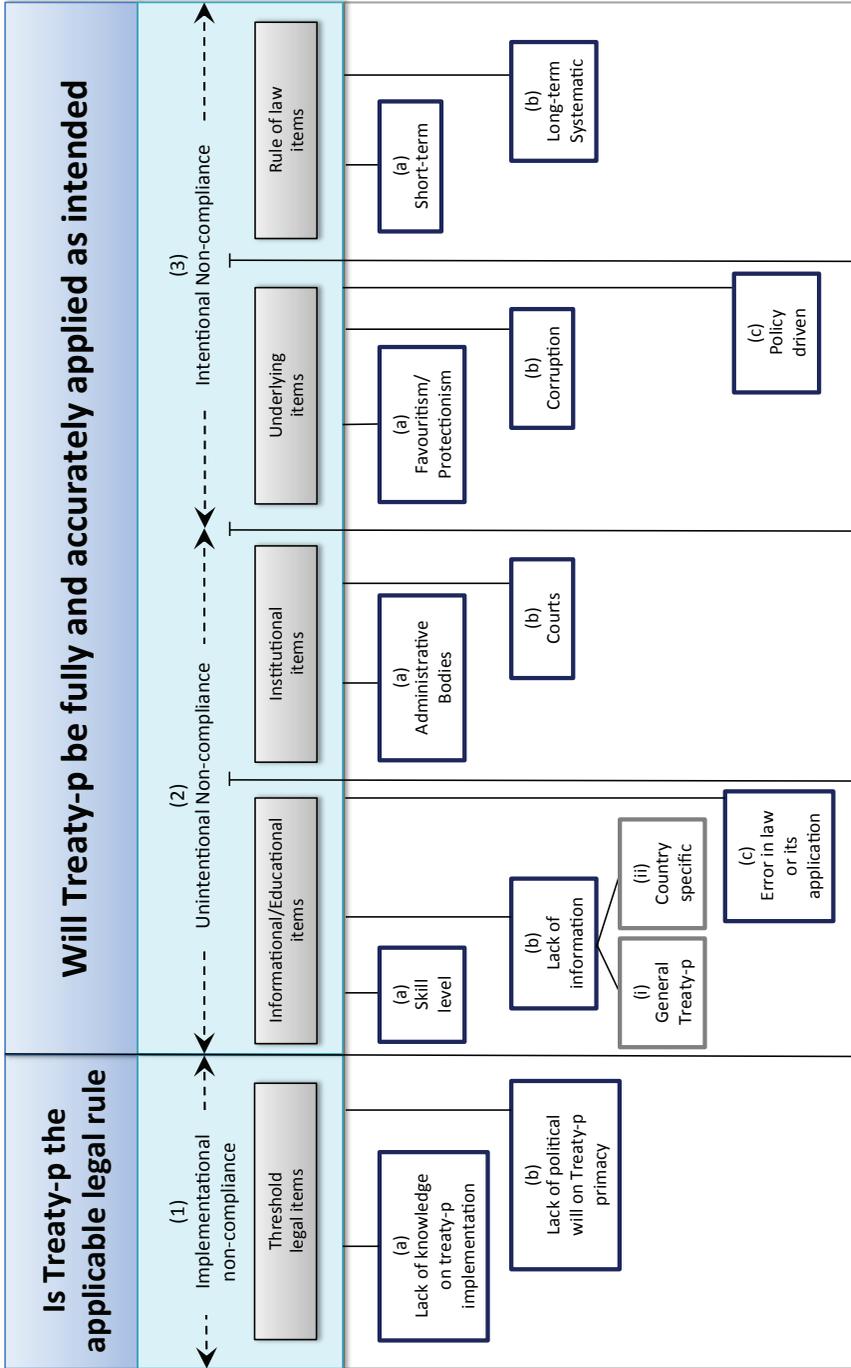
Benchmarking Expected Benefits from Treaty-p

	<u>No Expectation of Compliance</u>	<u>Expectation of Compliance</u>
<u>No Reduction of Transaction Risk</u>	No Economic Benefits	No Economic Benefits
<u>Reduction of Transaction Risk</u>	No Economic Benefits	Economic Benefits

In this figure, we depict reductions of transaction risk and expectations of compliance as binary variables. We do so for conceptual clarity. However, a more sophisticated depiction would set out expected benefits as the result of the complementary interaction of increasing compliance expectations and greater reductions of transaction risk.

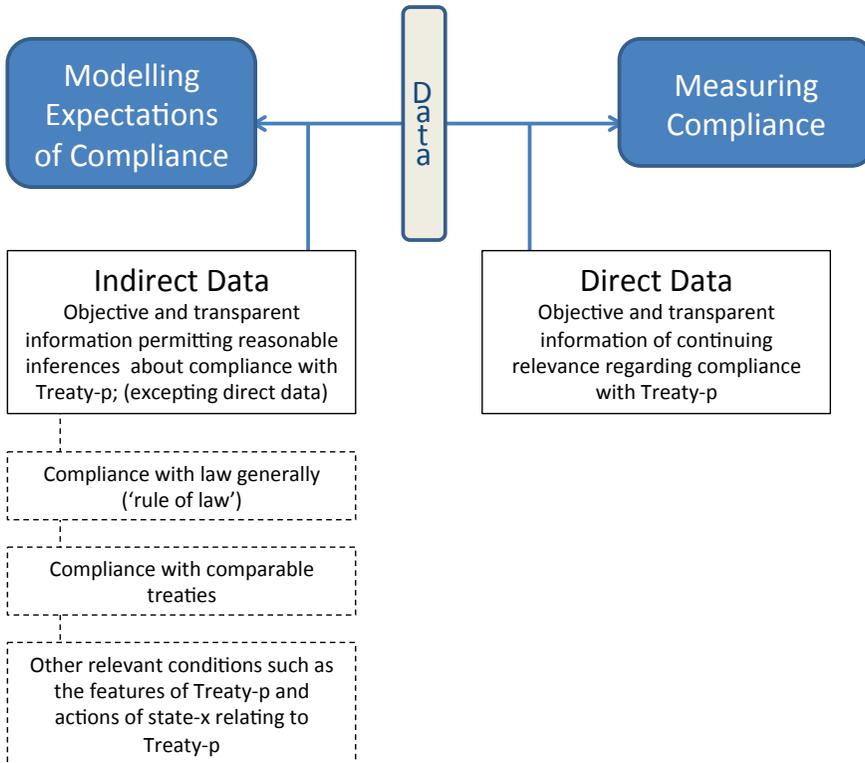
Annex II

Main Sources of Potential Non-compliance with Treaty-p



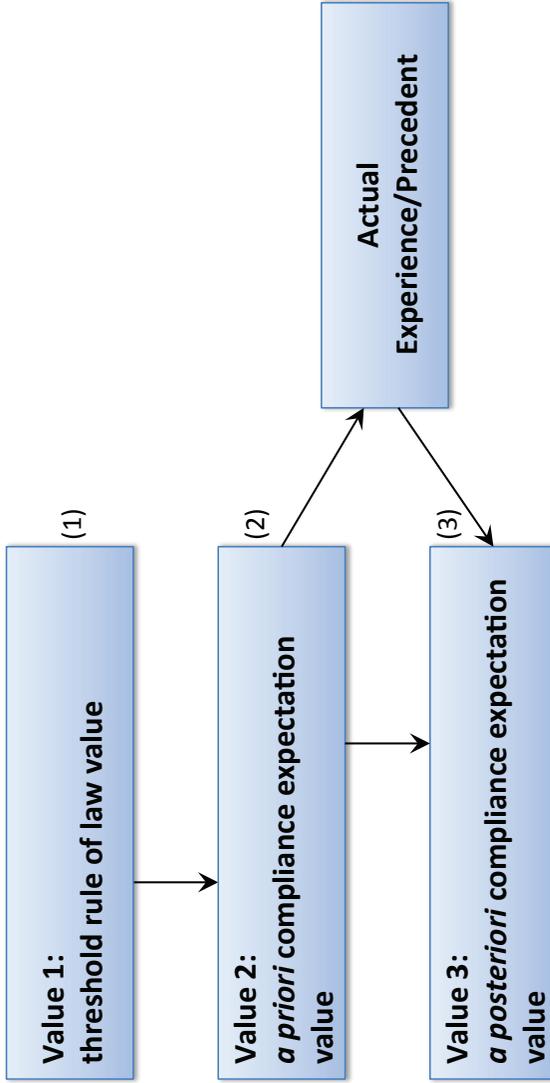
Annex III

## Relationship Between Measuring Compliance and Modelling Expectations of Compliance with Treaty-p



## Annex IV

## General Compliance Assessment and Valuation Model of Treaty-p\*



\* The terms 'value' and 'adjust' are used conceptually, not numerically. The highest 'value' is the maximum point on a spectrum and the minimum value is the lowest point on that spectrum. A value is 'adjusted' along that spectrum. The extent of the adjustment reflects the weight of the contextual considerations or precedent, as the case may be.

(1) There are various possible sources for this starting point value, including the indices produced by the World Justice Project. Other candidates include the country risk ratings of the major international credit rating agencies. A composite system could also be developed for this specific context.

(2) The maximum value of Value 2 is what is assigned assuming full treaty compliance. Value 2 would reflect the full risk reduction effected by Treaty-p, if fully and accurately applied. For a contracting state with a high Value 1 (a low rule of law risk) or a very low Value 1 (a very high rule of law risk), such Value 1 and Value 2 will be substantially the same (in other words, in the case of the former, there is a strong presumption of compliance, and in the case of the latter, there is not, and, in either case, changes are principally made only made through compliance experience (Value 3)). For a contracting state with a low to mid-level Value 1 (a high to mid rule of law risk), such Value 1 and Value 2 may be substantially different based on the contextual considerations; such Value 2, likewise, would be subject to changes through compliance experience (Value 3).

(3) The maximum value of Value 3 is same as Value 2. Actual precedent will likely outweigh contextual considerations, however sound the reasoning on the latter may be. It is essential that systems be put in place for the collection, assessment, and dissemination of precedent to help justify or improve the economic benefits of Treaty-p based on assumed compliance with it.