

# *Pacta Sunt Servanda* once again: the story of Greece and Ireland

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Enda Kenny's recent statement (25 June 2015) in support of the "debt reprofiling" of sovereign Greek liabilities might well have provoked wry smiles in those who have been following the European debt crisis over the past seven years.<sup>1</sup> The attempts of the Irish government to renegotiate the terms of the 2008 bank guarantee were infamously met in 2012 by the peremptory response of Olli Rehn, then EU Commissioner for Economic and Monetary Affairs, that "*pacta sunt servanda*" ("commitments must be honoured").<sup>2</sup> Ireland, that is to say, was told in no uncertain terms to respect its commitments and obligations. No renegotiation of the bank guarantee was permitted.

The complaints of Fintan O'Toole in *The Irish Times* and those of Colm McCarthy in *The Irish Independent* (to name only the most prominent commentators) about the inapplicability of this legal maxim to the Irish situation were evidently unpersuasive to the EU Commission.<sup>3</sup> Earlier this year, on the eve of the Greek elections, Pierre Moscovici, the new EU Commissioner for Economic and Financial Affairs, professed himself to be blithely unconcerned with the outcome of the Greek poll: "whatever is the choice of the Greek people, we have answers ... the commitments of the Greek government are the commitments of the country and that *pacta sunt servanda*".<sup>4</sup>

It would seem therefore, that, as far as the EU Commission is concerned, the Latin phrase *pacta sunt servanda* has a kind of self-evident legal force when applied to the sovereign debt crises in the EU. It apparently allocates liability for indebtedness with the sort of unarguable conviction and lucid economy that only a dead language can bestow. In his observations about the Irish situation in 2012, Olli Rehn was correct when he said that the principle *pacta sunt servanda* had a long legal and historical tradition behind it.<sup>5</sup> It might be useful to examine that tradition to see whether it supports the Commission's position about the legal obligations of the Irish State.

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<sup>1</sup> Stephen Collins, Suzanne Lynch, 'Enda Kenny urges Greece to follow Irish debt example', *The Irish Times*, 26 June, 2015.

<sup>2</sup> Arthur Beesley, 'Rehn says State must pay €3.1 bn Anglo bill due later this month', *The Irish Times*, 14 March, 2012.

<sup>3</sup> Fintan O'Toole, 'What's Latin for tear up these odious notes?', *The Irish Times*, 20 March, 2012; Colm McCarthy, 'This burden of bank debt is simply not sustainable', *The Irish Independent*, 18 March, 2012.

<sup>4</sup> 'EU's Moscovici: EU prepared for all scenarios after Greek vote', Reuters, 19 January 2015.

<sup>5</sup> The Beesley article (as note 2) quotes Rehn: "I actually wonder why this has to be asked at all because the principle in the European Union and in the long European legal and historical tradition is, in Latin – *pacta sunt servanda* – respect your commitments and obligations".

The matter is complicated because *pacta sunt servanda* is a doctrine both of private law and of public international law. The phrase itself was popularized by Hugo Grotius, the celebrated seventeenth century jurist and theoretician of natural law; its salience in natural law theory provides a vital clue to its proposed legal effect.<sup>6</sup> In its private law aspect a better historical translation than “commitments must be honoured” for *pacta sunt servanda* is “all commitments must be honoured”. This is because the doctrine was developed in the early modern period in conscious distinction to the Roman law tradition that a “naked” agreement (*nudum pactum*), i.e. one not clothed with the requisite formalities, could not found a legal obligation (although it might give rise to a legal defense).<sup>7</sup> This Roman emphasis on form was odious to the natural law temper of the seventeenth and eighteenth centuries, which instead held that “naked” agreements (*nuda pacta*) should indeed be binding.<sup>8</sup> The new attitude to the binding force of purely consensual agreements was even supported by virtue of what was believed to be ancient Germanic customary law and with reference to a famous passage in the *Germania* of Tacitus, where the Germans would voluntarily enter into slavery in order to satisfy their gambling debts (“they call it ‘honour’” wrote Tacitus; he himself thought this was a wicked practice).<sup>9</sup>

The emergence of natural law ideas in the Early Modern Period gave rise therefore to the new idea of a general law of contract unhampered by formal requirements, and based primarily on the intentions and the consensus of the parties. It is for this reason that civil law systems today exhibit what Richard Hyland has called “a more friendly attitude [than that of the common law] to the judicial enforcement of promises”<sup>10</sup>. Ireland, however, like other common law jurisdictions, has a different doctrinal basis to

<sup>6</sup> Kaius Tuori, ‘The Reception of Ancient Legal Thought in Early Modern International Law’, *The Oxford Handbook of the History of International Law* (Oxford, 2012), p. 1027. The phrase is most obviously associated with the natural law theorists of the seventeenth century, but it also has roots in medieval canon law: Reinhard Zimmermann, *The Law of Obligations: Roman Foundations of the Civilian Tradition* (Oxford, 1996), pp. 542-544.

<sup>7</sup> See, for example, *The Digest of Justinian*, trans. Alan Watson (Philadelphia, 1998), 2.14.7.4, Ulpian: “a naked agreement gives rise not to an obligation but to a defense”. This statement by Ulpian, preserved in the Digest, subsequently became very famous and influential, but the reality of Roman contract law was considerably more complex than the clear doctrinal situation it suggests. For purely consensual contracts in Roman law see J.A. Crook, *Law and Life of Rome 90 B.C. – A.D. 212* (Ithaca, 1967), pp. 214-215.

<sup>8</sup> Zimmermann, *The Law of Obligations* (as note 6), pp. 539-540.

<sup>9</sup> Tacitus, *Germania*, chapter 24.

<sup>10</sup> Richard Hyland, ‘The American Experience: Restatements, the UCC, Uniform Laws, and Transnational Coordination’, in A. Hartkamp et al. (eds), *Towards a European Civil Code* (Nijmegen, 2004), p. 72.

its law of contract and, as a general rule, requires consideration to move from the parties. The basic idea underlying the doctrine of consideration is one of reciprocity: “something of value in the eye of the law” must be given by one party in order to make another’s promise enforceable as a contract.<sup>11</sup> So as a matter of domestic contract law, when the civilian jurist says “*pacta sunt servanda*”, the Irish lawyer is entitled to reply that not all agreements are contractually binding, only those that have, inter alia, the requisite form. All this is by way of saying that there is more than one legal tradition within the European Union. That diversity is liable to be obscured by the blanket assertion of elastic and decontextualized maxims such as *pacta sunt servanda*. The phrase does nothing to illuminate the real legal question at the heart of the Irish bank guarantee, which goes to the binding nature (if any) of the commitment to guarantee domestic bank deposits and debts. Not the commitment itself, but its bindingness as a matter of law is the issue.

Things are different again when we move on to the plane of public international law, which is the only possible legal basis binding the Irish State to the terms offered under the bank guarantee. *Pacta sunt servanda* in its public international law aspect took its colour from the contemporary need in the mid-seventeenth century to put an end to the endemic warfare between sovereign states that had characterized the Thirty Years War (1618-1648).<sup>12</sup> As a doctrine of public international law, it has many analogies with its private law counterpart; both are premised on good faith, and both can be mitigated under certain conditions. In a nutshell, *pacta sunt servanda* demands that sovereign parties to an international treaty should abide by the terms of the treaty in good faith. This longstanding customary principle of public international law has been codified relatively recently in *The Vienna Convention on the Law of Treaties* (1969). Article 26 of the treaty provides that “every treaty in force is binding upon the parties to it and must be performed by them in good faith”. As well as incorporating the *pacta sunt servanda* rule, the Vienna Convention also codifies two customary exceptions that allow states to derogate from the strictness of the rule: Article 61, concerning impossibility of

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<sup>11</sup> *Thomas v Thomas* (1842) 2 Q.B. 851 at 859, per Patteson J. Consideration is not necessary when the promise takes effect as a deed: *Treitel on the Law of Contract, twelfth edition*, Edwin Peel (ed) (London, 2007), pp. 171-172, para. 3-164.

<sup>12</sup> Tuori, ‘Reception’ (as note 6), pp.1027-1028.

performance as a ground for terminating treaty obligations; and Article 62, concerning fundamental change of circumstances as a ground for terminating treaty obligations.<sup>13</sup>

It has already been argued by many commentators, with considerable force and logic, that *pacta sunt servanda* as a public law doctrine cannot attach to the Irish bank guarantee of 2008, which was a formally internal arrangement – albeit one with enormous international repercussions – between the Irish government and its domestic banks.<sup>14</sup> The bank guarantee had none of the attributes of an international treaty between sovereign states that might attract the operation of the doctrine *pacta sunt servanda*. That doesn't quite end the matter, however. There was another doctrinal resource available to Mr. Rehn in 2012 to legally justify holding Ireland to its commitments under the bank guarantee.

There is some authority for the proposition that a state can incur international legal obligations by virtue of its own unilateral act, without the formalities of a treaty or the participation of any other state party. In the *Nuclear Tests Case* of 1974 the International Court of Justice held that unilateral declarations could have the effect of creating legal obligations:

“when it is the intention of the State making the declaration that it should become bound according to its terms, that intention confers on the declaration the character of a legal undertaking, the State being thenceforth legally required to follow a course of conduct consistent with the declaration”.<sup>15</sup>

There follows an important passage, analogizing unilateral acts with the doctrine of *pacta sunt servanda*:

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<sup>13</sup> For this characterization (i.e. that the Vienna Convention codifies the relevant principles of customary international law) see, as it concerns change of circumstances, the *Fisheries Jurisdiction* case (Federal Republic of Germany v Iceland), 1973 I.C.J. Rep. 49, para. 36. See also Christina Binder, 'Stability and Change in Times of Fragmentation: The Limits of *Pacta Sunt Servanda* Revisited', *Leiden Journal of International Law* 25 (2012), p. 911 note 8.

<sup>14</sup> See, for example, the Fintan O'Toole article (as note 3), referring to the definition of *pacta sunt servanda* in international law offered by the Court of Arbitration at the Hague.

<sup>15</sup> 1974 I.C.J. Rep. 253, para. 43.

“just as the law of *pacta sunt servanda* in the law of treaties is based on good faith, so also is the binding character of an international obligation assumed by unilateral declaration. Thus, interested states may take cognizance of unilateral declarations and place confidence in them, and are entitled to require that the obligation thus created be respected”.<sup>16</sup>

How do these observations of the International Court of Justice apply to the Irish situation in 2008? The bank guarantee was clearly a unilateral act but there are considerable difficulties in characterising it as one that was legally oriented towards the international as opposed to the domestic arena. For the sake of argument, however, let's give the bank guarantee a maximalist legal interpretation such that it indicated an intention on the part of the Irish government to be bound internationally according to its terms.

Does that vindicate the Commission's unyielding stance in 2012? The answer is “no”, for three reasons. The first reason is found in the text of the *Nuclear Tests Case* judgment itself: “when States make statements by which their freedom of action is to be limited, a restrictive interpretation [of those statements] is called for”.<sup>17</sup>

The second reason has to do with the quantum of the cost that the Irish government understood itself to be underwriting by virtue of the guarantee. The bank guarantee in 2008 was premised on the assumption that the cost to the State would be no worse than roughly €20 billion; a Merrill Lynch report for the government in November of that year estimated the cost of the rescue at €16.4 billion at most. But, as has now become evident, this was a gross under-estimate. At least partly because of the incomplete information made available to the government on the fateful night of September 29, the exchequer was persuaded into standing over a guarantee that, at the time of writing, has cost in excess of €100 billion.<sup>18</sup>

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<sup>16</sup> Ibid., para. 46.

<sup>17</sup> Ibid., para. 44.

<sup>18</sup> Ciarán Hancock, 'Patrick Honohan: Cost of bust well over €100bn and growing', *The Irish Times*, 26 June, 2015.

It is clear, therefore, that the guarantee was made on the basis of an error of fact. To find guidance on how International Public Law treats binding obligations undertaken in error, we can look again to the Vienna Convention on the Law of Treaties. Article 48(1) of the Convention stipulates that “a state may invoke an error in a treaty as invalidating its consent to be bound by the treaty if the error relates to a fact or situation which was assumed by that state to exist at the time when the treaty was concluded and formed an essential basis of its consent to be bound by the treaty”. Applying this principle to the circumstances of the bank guarantee (and transposing from a treaty obligation to a unilateral one), it is fair to say that the Irish government’s fundamental misapprehension about the scale of the cost involved formed an “essential basis” of its consent to be bound by the guarantee. It is unimaginable that the cabinet would have approved the guarantee if it had knowledge of its true cost.

By itself, however, an error does not necessarily terminate or excuse an obligation as a matter of Public International Law. Article 48(2) of the Vienna Convention qualifies the foregoing as it provides that “paragraph 1 shall not apply if the state in question contributed by its own conduct to the error or if the circumstances were such as to put the state on notice of a possible error”. How this provision might apply to the events of September 29, 2008 is a matter of some delicacy and would involve an analysis of policy choices and contemporary knowledge that is beyond the scope of this paper. In the spirit of exploring as many legal avenues as possible, however, let’s assume once more either that the government’s conduct in sanctioning the bank guarantee was imprudent (i.e. that the government contributed “by its own conduct” to the relevant error), or that the cabinet should have had more accurate knowledge about the true nature of the banks’ financial situation (i.e. that the circumstances in 2008 were such as to put the state “on notice” of a possible error). On the basis of that assumption, s. 48(1) would not apply – nor would any analogous principle of customary international law – and the Irish State would therefore not be able to invoke error as a doctrine of Public International Law in order to be excused from any obligations incurred under the bank guarantee.

This takes us to the third reason that might justify terminating or modifying any binding international commitment flowing from the 2008 guarantee. The global credit crisis that began in 2008, and the catastrophic contraction that subsequently

economy, may well amount to a valid reason to relax the legal force of any international obligation taken on by the Irish State in September 2008. The global economic crisis, that is to say, might allow the invocation of the “fundamental change of circumstances” idea enshrined in Article 62 of the *Vienna Convention on the Law of Treaties*.

Article 62 codifies the principle of customary international law known as the *clausula rebus sic stantibus*. This *clausula* “with things standing thus” expresses the idea that a treaty is binding only insofar as circumstances remain as they were at the conclusion of that treaty. If there is a fundamental change in those circumstances, there may be scope for a state party to derogate from its treaty obligations. This doctrine has been interpreted very strictly by the International Court of Justice. It has an obvious application, however, to the effect of the global crisis on the capacity of the Irish State to repay the cost of the bank guarantee (leaving aside, momentarily, the fact that we are assuming the ground of the Irish obligation to be a unilateral act rather than an international treaty). In the Fisheries Jurisdiction case the International Court of Justice made it clear that “the [fundamental] change must have increased the burden of the obligations to be executed to the extent of rendering the performance something essentially different from that originally undertaken”.<sup>19</sup> This difficult threshold would seem to be satisfied by the global economic crisis that eventuated after the bank guarantee of 2008. The full effect of the crisis only became manifest in the years following the guarantee, ultimately making that obligation so onerous that performance required the EU and IMF bailout of the Irish State in 2010.<sup>20</sup> That is to say, the global crisis increased the burden of the obligation so dramatically that performance of the bank guarantee turned out to be something “essentially different” from that originally undertaken.

There is a good historical pedigree, moreover, for this kind of argument in the realm of sovereign financial obligations. For example, the thorny issue of German war reparations in the aftermath of World War I culminated in the Young Plan of 1929,

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<sup>19</sup> See the *Fisheries Jurisdiction* case (as note 132), paras 36-43, especially para 43.

<sup>20</sup> It is worth emphasizing that the Irish bank guarantee was made in a very unclear situation right at the start of the global crisis (a mere two weeks after the key triggering event, the collapse of Lehman Brothers bank), and that the full magnitude and effect of the crisis only crystallized in the years that followed. I.e., the most realistic temporal characterization of the crisis is to see it as a supervening event that occurred after the bank guarantee.

whereby Germany was required to pay 37 billion marks in reparations within fifty nine years. The supervening crisis of the Great Depression catastrophically affected Germany's ability to repay these reparations, and Germany requested a renegotiation of terms on the basis of the principle *rebus sic stantibus*.<sup>21</sup> The upshot of the renegotiations that ensued was the Lausanne Conference of 1932 which, effectively, ended the reparations régime that had been in place since the Treaty of Versailles.<sup>22</sup>

The principle *rebus sic stantibus* has the potential to seriously impair and modify the binding nature of treaty obligations (and, by extension, any unilateral sovereign acts that create international obligations). As had been pointed out by the German legal historian Reinhard Zimmermann, although the *clausula rebus sic stantibus* modifies quite substantially the force of the legal prescription *pacta sunt servanda*, both maxims have a common root and justification in human volition and intentionality.<sup>23</sup> That is to say, they both derive their legal force from the intention of a party to a contract or a treaty to be bound by it. Because it is premised on the requirements of intention rather than form, the apparently absolute principle of *pacta sunt servanda* thus contains within itself the seeds of its own limitation, namely the more contingent principle of *rebus sic stantibus*.

Just as it applies to treaties and contracts, moreover, the “fundamental change of circumstances” principle surely applies with equal force and logic to the intentional, unilateral acts discussed by the International Court of Justice in the *Nuclear Tests Case*. The only basis of the international obligations contemplated by the International Court of Justice in that case is the *intention* of the declaring State to be bound. If the

<sup>21</sup> See para. 15 of the article ‘War Reparations’ by Pietro Sullo and Julian Wyatt in the *Max Planck Encyclopedia of Public International Law*, Rüdiger Wolfrum (ed) (published online by Oxford University Press).

<sup>22</sup> A definitive end to the process initiated by the Lausanne Conference was only reached in 1953 with the *London Agreement on German External Debts*, which provided for a 62.6 % relief of the debt owed by Germany to a number of sovereign countries (including Ireland and Greece): Rutsel Silvestre J. Martha, *The Financial Obligations in International Law* (Oxford, 2015), pp. 170-171. See also Martha's observations on p. 170 concerning the applicability of the principle of fundamental change to the renegotiation of international financial obligations. An important point in this context is that, as a principle of public international law, fundamental change might well permit the termination or modification of obligations on the basis of the increased cost burden imposed on a given sovereign state. The common law doctrine of frustration, on the other hand – which is the functional domestic law equivalent of the principle *rebus sic stantibus* – typically does not allow one party to be excused from its obligations simply because the costs associated with performance have increased.

<sup>23</sup> Zimmermann, *The Law of Obligations* (as note 6), pp. 579-581.

circumstances underpinning that intention change – as global economic circumstances changed in the years following the bank guarantee – it makes perfect sense to allow the declaring state to resile from its obligation . And so, giving the events of 2008 the interpretation most favourable to the Commission’s position, as expressed by Olli Rehn, there was no legal basis for denying the Irish government the opportunity to renegotiate the bank guarantee as the true burden and effect of that guarantee crystallized in the years after 2008.

As a final caution to those who would chant uncritically the mantra of *pacta sunt servanda*, it should be pointed out that the *clausula rebus sic stantibus* has had a remarkably tenacious existence both as a matter of international law and as matter of municipal law. It is a principle of customary international law (the EU, by the way, has been quite candid in acknowledging the juridical fact that customary international law constitutes a source of European Union law) and, we have seen, it has been codified in Article 62 of the *Vienna Convention on the Law of Treaties*. The *clausula* is also relevant in domestic legal systems. It has its analogy in common law jurisdictions in the contractual doctrine of frustration , and it forms the basis of the German contractual doctrine of *Wegfall der Geschäftsgrundlage* (i.e. collapse of the underlying basis of the transaction).<sup>24</sup> There is more than one relevant legal maxim in the long European legal and historical tradition extolled by Commissioner Rehn.

The reader might well wonder if any of this matters. As it concerns the banking crisis, it might be said, paraphrasing Auden, that legal argument makes nothing happen. And it does seem very late in the day to offer a legal riposte concerning the bank guarantee to Olli Rehn and his successors at the European Commission. But, however implausible, legal arguments only have a chance of success if they are made.

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<sup>24</sup> *Ibid.*, pp. 581-582. See also Simon Whittaker and Reinhard Zimmermann, ‘Good faith in European contract law: surveying the legal landscape’, Reinhard Zimmermann and Simon Whittaker (eds), *Good Faith in European Contract Law* (Cambridge, 2000), pp. 25-26.