THE SANDLINE AFFAIR
ILLEGALITY AND INTERNATIONAL LAW[†]

Damian Sturzaker[*]
Craig Cawood[**]

INTRODUCTION

A recent dispute arising out of an agreement between the government of Papua New Guinea ("PNG") and the mercenary outfit, Sandline International Inc ("Sandline"), set off a series of events including a constitutional crisis, the overthrow of a government and litigation in different jurisdictions. The matter was heard, first before an Arbitral Tribunal and then on appeal to the Supreme Court of Queensland. The result of this case, *Independent State of Papua New Guinea v Sandline International Inc ("Sandline case")*[1] may have far reaching effects on the way parties frame international arbitration agreements, in particular on the choice of law and place of arbitration.

The Arbitral Tribunal found that the law governing the agreement was international law and not the laws of England, notwithstanding the fact that the agreement had expressly stipulated that the laws of England should apply to the agreement. As a result, PNG sought leave to appeal the decision to the Supreme Court.

In Australia, a court has limited opportunities to interfere with arbitral awards under the legislation that governs the procedure for the conduct of arbitrations. Just how limited the court's right to review an arbitral decision was demonstrated in this case when the court held that the application of foreign law by the Arbitral Tribunal was a question of fact, not law, and hence not appealable. The decision may be interpreted to mean that where a tribunal sitting in Australia applies foreign law to determine the issues

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[*] BA, Dip Int Law, LLM; Solicitor of the Supreme Court of New South Wales.
[**] B Juris, LLB, Solicitor of the Supreme Court of New South Wales.
[1] Judgment delivered on 30 March 1999, BC 9901173 (1999, Butterworths, North Ryde) (as yet unreported).

between the parties, a party aggrieved by the decision would be prevented from appealing that decision unless the arbitration was conducted improperly and without procedural fairness. The decision effectively prevents the aggrieved party from appealing an arbitral decision to a court where the law of the place of the arbitration is different from the law that the parties had agreed upon would govern the agreement.

The unsatisfactory outcome of the Supreme Court decision in this case is exaggerated by the fact that the original decision of the Arbitral Tribunal is arguably unsustainable in law. In fact, the almost universal practice of states is that the conduct by a private corporation of actual offensive operations on the territory of a state would be unlawful unless expressly sanctioned by statute.[2]

BACKGROUND

On 31 January 1997, the Prime Minister of PNG[3] and Sandline entered into an agreement whereby Sandline would provide the manpower, equipment and skills to assist the armed forces of PNG to overcome by military means a group referred to in the agreement as "the illegal and unrecognised Bouganville Revolutionary Army". All Sandline personnel involved in the performance of Sandline's obligations under the agreement were to be enrolled as "Special Constables" of PNG. As such, they were required to carry appropriate identity cards in order to undertake legally their assigned roles. For Sandline's trouble, they were promised a fee of US$36 million. Half of this sum was payable when the agreement was entered into and the balance was payable within 30 days of Sandline deploying a Command Administration and Training Team ("CATT") of 16 men within PNG at the places specified in the agreement.

PNG made the initial payment. However, following the deployment of the CATT by Sandline in March 1997, Sandline had an additional 80-man unit outside Port Moresby. This presence angered the PNG army and almost prompted a military coup. The army, led by Brigadier-General Jerry Singirok, mutinied and riots broke out in Port Moresby. The country

[2] For example, under English law, legislation had to be passed to permit the private conduct of prisons: 1991 Criminal Justice Act (UK) section 84; 1994 Criminal Justice and Public Order Act (UK) section 96.

[3] At the time, Sir Julius Chan.

plunged into its most serious political crisis in 22 years of independence. Sandline's chief, Colonel Tim Spicer, was arrested and deported. He later gave evidence to the inquiry that was established to investigate the incident, and his evidence helped bring down the government.

Sandline then made numerous demands for all outstanding moneys under the agreement. The PNG government refused to pay. In accordance with the arbitration clause in the agreement, the dispute was referred to a three-member arbitral tribunal. The governing law was said to be English law and the arbitration was conducted in Cairns, Queensland.[4]

THE ISSUE BEFORE THE ARBITRAL TRIBUNAL[5]

The Arbitral Tribunal was constituted according to the UNCITRAL Rules. At the arbitration PNG argued that the agreement was not enforceable for reasons of illegality and this proposition rested on two grounds:

1. the agreement was illegal under the laws of PNG because it contravened not merely section 200 of the Constitution[6] but also certain other domestic statutory laws; and

2. international law, applied as part of the laws of England in a case such as the one before the Tribunal, treated as illegal the agreement between the parties and thus the agreement was unenforceable according to the laws of England.

PNG therefore submitted that English law governed the agreement and it was irrelevant what international law might say about the capacity to contract and the obligations of the parties under the contract.

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[4] Not surprisingly, the arbitration received wide publicity and contrary to the normal confidential nature of most arbitrations, details of the proceedings were available to the public via news reports and over the world wide web.

[5] The Arbitral Tribunal in the Matter of Sandline International Inc v The Independent State of Papua New Guinea at Cairns on 9 October 1998 (Rt Hon Sir Edward Somers, the Rt Hon Sir Michael Kerr, and the Hon Sir Daryl Dawson presiding).

[6] Under section 200(3) of the Constitution of PNG, an act of parliament is necessary to allow the armed forces of any other country to "establish, equip, train or take part in military or para-military training" in PNG. In would be anomalous if the armed forces of a foreign state could not so act without legislation, whereas mercenary forces could be authorised by an executive decision.

APPLICABLE ENGLISH LAW

English law on this subject is clear. Where the performance of a contract is illegal under the law of the place in which performance is to take place, then irrespective of what the law of the contract is, the contract will be unenforceable. This rule is established in *Ralli Bros v Cia Naviera Sota Y Aznar ("Ralli Bros").*[7] However, the rule has two exceptions and the contract is enforceable if: (1) the illegal part may be severed and the legal part performed;[8] and (2) the contract may be performed in another manner without the laws of the place of performance being breached.[9]

In the circumstances of the *Sandline case,* the application of the rule in *Ralli Bros* should have provided no difficulty. Accordingly, by applying English law to the agreement, the agreement should have been unenforceable. However, the Arbitral Tribunal did not see the problem in this light.

THE ARBITRAL DECISION

On 9 October 1998 the Arbitral Tribunal rejected the defence of PNG and held that PNG was obliged to pay Sandline US$18 million plus interest under the agreement. The Tribunal declined to rule on the first ground stating that such a determination was better left to PNG courts. It stated:

> The Tribunal is of the view that it is neither necessary nor desirable to express any final opinion upon the scope of the section [section 200 of the PNG Constitution], it being possible to reach a conclusion for the purposes of this Interim Award by assuming, without deciding, the illegality or unlawfulness under the section for which PNG contends. The scope and intent of s. 200 is better left to the courts of PNG where knowledge and understanding of the local conditions give them a better and more accurate assessment of its effect.[10]

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[7] [1920] 2 King's Bench 287; see also R v International Trustee for the Protection of Bondholders AG [1937] Appeal Cases 500 per Lord Wright at 519; Regazzoni v KC Sethia (1944) Limited [1958] Appeal Cases 301; Euro-Diam Ltd v Bathurst [1990] Queen's Bench 1 per Staughton J at 14.

[8] United City Merchants Limited v Royal Bank of Canada [1982] Queen's Bench 208 (Court of Appeal).

[9] Toprak Mahsulleri Ofisi v Finagrain Compagnie Commerciale Agricolo et Fianciere SA [1979] 2 Lloyd's Reports 98 (Court of Appeal).

[10] Arbitral Decision at para 8.2.

However, the Arbitral Tribunal dealt at length with PNG's second ground, that the illegality of the agreement under PNG law was a defence to a claim for payment under the terms of the agreement.

On this point, the Tribunal reasoned as follows:

> The rules of international law in this case are clearly established and their application causes no difficulty. PNG submits that they have no application because the agreement between it and Sandline, a private party, does not attract international law. However, it is incontrovertible that PNG is an independent state and purported to contract in that capacity. An agreement between a private party and a state is an international, not a domestic, contract. This Tribunal is an international, not a domestic, arbitral tribunal and is bound to apply the rules of international law. Those rules are not excluded from, but form part of, English law, which is the law chosen by the parties to govern their contract. PNG cited no authority to support its submission and there is ample authority to the contrary...The submission by PNG must be rejected.[11]

The Tribunal continued:

> In international law, in relation to a contract to which a state is a party and which are to be performed within the territory of that state, the principle and the authorities referred to in paragraph 9.1 above have no application or must at any rate give way to a fundamental qualification. That is that a state cannot rely upon its own internal laws as the basis for a plea that a contract concluded by it is illegal. It is a clearly established principle of international law that the acts of a state will be regarded as such even if they are ultra vires or unlawful under the internal law of the state. Of course, a state is a juristic person and can only act through its institutions, officials or employees (commonly referred to in international law as organs). But their acts or omissions when they purport to act in their capacity as organs of the state are regarded internationally as those of the state even though they contravene the internal law of the state.[12]

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[11] Ibid at para 10.1.
[12] Ibid at para 10.2.

SHOULD INTERNATIONAL LAW APPLY TO THE AGREEMENT?

The Arbitral Tribunal held that because the agreement was between a private party and a state, international law applied necessarily.

This proposition is inconsistent with a long and consistent line of compelling authority. In fact, there is no example of an arbitral tribunal applying international law in the face of a clear and exclusive choice of domestic law. All the cases relied upon by the Arbitral Tribunal were cases where there was no clear choice of law in the contract or no agreement between the parties during the arbitral proceedings on what the applicable law should be.[13] Further, they were cases where the arbitral tribunal was specifically authorised to apply international law.

Even if some passages of *dicta* in the cases relied upon by the Arbitral Tribunal were not entirely clear on this point, it was evident that international law applied in the *Sandline case,* together with or to the exclusion of domestic law. This is because international law may be applied to:

(1) long-term development or concessionary contracts; or

(2) cases where the applicable domestic law is primitive or insufficiently modernised to deal with the contract in question.[14]

None of the cases relied on by the Arbitral Tribunal dealt with the situation of fundamental illegality in the place of performance. All the cases relied on dealt with situations in which the state party had altered the law to its own advantage or had sought to plead relatively minor deficiencies in the manner in which the contract was concluded. However, in the *Serbian Loans case,*[15] the Permanent Court of International Justice had stated that:[16]

> any contract which is not a contract between States in their capacity as subjects of international law is based on the domestic law of some country.

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[13] Refer ibid at para 10.2.
[14] Lord McNair "The general principles of law recognised by civilized nations" (1957) 33 British Yearbook of International Law 1, 19.
[15] [1929] Permanent Court of International Justice Reports, Series A, No 20.
[16] Ibid 41.

The fact that in recent years there has been much discussion on the "internationalisation" of contracts between states and non-state entities does not detract from the force of the basic proposition above. Rather, there must be some evidence in the contract itself, or in the surrounding circumstances, that international law is to apply to the contract.

The general position is stated clearly by Professor Ian Brownlie: [17]

> The rules of public international law accept the normal operation of rules of private international law, and when a claim for breach of contract between an alien and a government arises, the issue will be decided in accordance with the applicable system of domestic law designated by the rules of private international law.

INCORPORATION OF INTERNATIONAL LAW INTO THE LAW OF ENGLAND

The "automatic incorporation" theory provides that international law is automatically incorporated into the law of England subject to contrary statutes. That is, international law may change rules of common law where those rules may be said to be no longer in accordance with modern international law.[18] However, rules of international law that are not clearly established, or are not certain in their content, do not "automatically incorporate" into domestic law. This is clearly stated in *Rayner (Mincing Lane) Ltd v Department of Trade and Industry* [19] where Lord Oliver stated:[20]

> A rule of international law becomes a rule – whether accepted into domestic law or not – only when it is certain and is accepted generally by the body of civilised nations; and it is for those who assert the rule to demonstrate it, if necessary before the International Court of Justice.

In light of this, can it be confidently asserted that there is a rule of international law which states that a state party to a contract cannot raise an illegality plea under the law of the place of performance, contrary to the

[17] Brownlie I, Principles of Public International Law (1998, 5th edition, Oxford University Press, Oxford) 553.
[18] Trendtex Trading Corporation v Central Bank of Nigeria [1977] Queen's Bench 529.
[19] [1990] 2 Appeal Cases 418.
[20] Ibid 513.

firmly established common law rule that such a contract will be unenforceable? The simple answer is no. The authorities, both international and in the United Kingdom, do not lead to the result that the contract between PNG and Sandline is to be judged by international law. On the other hand, the majority of cases support the view that where a question arises that is clearly within the province of international law, and that question can be answered only by reference to international law, the common law will incorporate international law in so far as it is a clear rule of international law and one that can be incorporated without adaptation. However, this is subject always to the overriding force of statute.

PNG'S APPLICATION FOR LEAVE TO APPEAL

PNG sought leave to appeal to the Supreme Court from the arbitral award under Section 38(2) of the 1990 Commercial Arbitration Act (Qld) on the basis that there was a "question of law arising out of the award".[21] The difficulty for PNG was that under Section 38 the court might not grant leave to appeal from an arbitral decision unless there is:

1. a manifest error of law on the face of the award; or

2. strong evidence that the arbitrator or umpire made an error of law and that the determination of the question may add, or may be likely to add, substantially to the certainty of commercial law.

PNG sought leave to appeal under Section 38(4)(b) of the Commercial Arbitration Act 1990 (Qld) also on seven questions of law. The majority of the questions centred on the allegation by PNG that the tribunal made an error of law when considering whether the agreement between Sandline and PNG was illegal under international law and therefore unenforceable according to the laws of England.

In the Supreme Court, Justice Ambrose raised this question: did "error of law" under the Queensland Act mean an error within Queensland domestic law or within the law of any state in the world? As he correctly asserted, if the latter construction was adopted it would greatly increase the curial

[21] This section is common to all of the various state acts in Australia: see 1986 Commercial Arbitration Act (SA) Section 38(2); 1985 Commercial Arbitration Act (WA) Section 38(2); 1984 Commercial Arbitration Act (Vic) Section 38(2); 1984 Arbitration Act (NSW) Section 38(2).

supervision of arbitrations in a state. Further, where a tribunal made a finding on the content of the foreign law to be applied, the court could grant leave to appeal under Section 38(4)(b) if the court took the view that there was a manifest error committed by the tribunal on the content of that foreign law.[22]

THE DECISION

Justice Ambrose concluded that to adopt the latter construction would be to depart from the attitude which domestic courts had adopted for centuries with respect to the application of foreign law. He stated:[23]

> [U]pon its proper construction S38(4) does not give this Court jurisdiction to entertain an appeal against an award where the only error of law complained of is an error of foreign law; upon its proper construction, the term "error of law" in S38 refers only to an error of Queensland or Australian law.

IMPLICATIONS OF THE *SANDLINE CASE*

The decision by Justice Ambrose strongly supports the proposition that where parties agree to an arbitration agreement with a clause that (1) includes a foreign choice of law and (2) provides for the arbitration to be conducted in Australia applying Australian procedural law, then any appeal from an arbitral tribunal to an Australian court would be extremely difficult. Despite PNG's attempts to demonstrate that the law of England in relation to illegality was identical to the law in Queensland, this was still not sufficient for a finding by the Arbitral Tribunal in relation to illegality amounting to a question of law.

Therefore, parties involved in international contracts should carefully consider whether they are content, first of all, in not having a right to appeal in situations where they have chosen foreign law and secondly, for the arbitration to be conducted in Australia according to Australian procedural law. Further, the absence of a right of appeal has implications concerning the parties' choice of arbitrators as the arbitration will very much be the final means of resolving disputes.

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[22] Judgment delivered on 30 March 1999, BC 9901173 (1999, Butterworths, North Ryde) 49 (as yet unreported).
[23] Ibid 108.

The final chapter in this unusual case was an announcement on 1 May 1999 by PNG Prime Minister, Bill Skate who said that his government would pay the sum of US$18million ordered by the Arbitral Tribunal including legal and other interests totalling US$25million. He explained that the decision was due to the fact that the unpaid arbitral award had hampered PNG's ability to raise US$250million through the country's first bond issue. As stated by Sandline's commercial adviser, Michael Grunberg:

> We sincerely hope that this draws a line underneath the affair and brings to an end a saga which has absorbed considerable time and expense for each of us over the last two years.[24]

[24] AAP news report on 3 May 1999.