Contracting with Sovereignty: State Contracts and International Arbitration

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The legal issues surrounding state contracts have always been controversial. There often happens to be an interplay of different laws in the context of state contracts such as municipal or domestic law, public international law and conflict of laws. To this, transnational law or the *lex mercatoria* often adds a new dimension depending on the contracting parties’ intention or even on the arbitrator’s preference in some cases. International arbitration, both contract-based and treaty-based, appears to be a growing institution to act as a vehicle for the development and refinement of the law to be applicable to various aspects of state contracts and arbitration. Over the last couple of decades the law relating to state contracts and contract and treaty arbitrations has developed exponentially. There are about 3000 bilateral investment treaties (BITs) and several multilateral ones such as the North American Free Trade Agreement (NAFTA) and the Energy Charter Treaty (ECT). Ever since the first investment treaty arbitration case2 relating to a BIT (UK-Sri Lanka) was decided in 1990 by the ICSID there has been a plethora of cases (now over 450)3 based on BIT issues and other investment treaties. All these developments are perhaps heralding an emerging new regime of international investment law.

The book under review has primarily made an appraisal of the recent developments in arbitral case law of both contract as well as treaty arbitrations in the context of state contracts. The book comprises seven chapters and is based on the author’s doctoral thesis. The aspects that prominently figure in the thematic discussion are the applicability of international law to state contracts, procedural aspects (*i.e.* jurisdiction and enforceability) of international arbitration, the concept of legitimate expectation in the context of contract claims and contractual restriction of public powers.

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2 *Asian Agricultural Products Ltd. v Sri Lanka* (ICSID Case No. ARB/87/3) (*AAPL*). The *AAPL* tribunal (Dr. Ahmed Sadek El-Kosheri (President), Professor Berthold Goldman and Dr. Samuel Asante).
3 UNCTAD notes: 2011 marks a new record with at least 46 new investment arbitration cases initiated against host countries - the highest number of known treaty-based disputes ever filed in one year. See online: <http://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=64>.
In the introductory chapter the author has clarified the scope of his book providing a roadmap which serious readers will find very helpful as the subject matter of the book is a complex one. This is followed (in chapter 2) by a panoramic sketch of the historical development of investment protection in international law from the institutional perspective such as mixed claims commissions, international commercial arbitration and investment treaty arbitration. Setting such a backdrop the author moves on to focus on the principal thematic aspects as mentioned earlier (chapters 3-6). Chapter 7 mainly summarises the main points in each chapter as a quick recap and offers some final comments in light of the findings and observations throughout the book. As a whole, the book is well structured, well presented and well thought out.

The book has dealt with a host of issues and given rise to a host of others in respect of state contracts and international arbitration. The review will focus on certain select ones. In his critique of the concept of internationalization of state contracts the author observes (p. 56) that the only objective of the choice of international law as applicable law to state contracts is to confirm the sanctity of contracts, *i.e.* *pacta sunt servanda* (agreements must be kept), which is also the foundational notion of Verdross’s theory of *contrat sans loi* (contract without law, *i.e.* contract itself being the law) (p. 49). The question is whether the chosen applicable law, *i.e.* international law, can, in fact, neutralise the legislative sovereignty of the state party concerned. The answer is no.

In both international law and general principles of law (a source of international law or transnational law derived from the major and representative legal systems of the world) there is no absolute application of the notion of *pacta sunt servanda* as this is limited by different respective versions of the doctrine of changed circumstances, *i.e.* *rebus sic stantibus*.⁴ Even the choice of international law as applicable law will not help the principle of *pacta sunt servanda* as an incantation, nor will Lord McNair’s prescription of anchoring economic development agreements as a special kind in a third legal order, *i.e.* the general principles of law (pp. 48-49) as in either domain the principle is not applied in the absolute sense. It seems that the purpose of the theory of internationalization of state contracts based on the notion of *pacta sunt servanda* in both verdross and McNair’s conceptualization does not go far. However, the author seems to have missed this point from the notion of positive law in practice in municipal law, international law and general principles of law. The author asserts that internationalization of state contract is effected by way of the “choice of law” approach as he finds authority of such a position in the writings of Mann, Weil and Leben (pp. 51-56). The theoretical underpinning of this position draws its inspiration from the conflictual methodology, but in practice a state contract cannot be fully internationalised like a treaty as the former involves many matters which are to be dealt with by the law of the host state, especially the aspects falling within the domain of the *loi de police* or mandatory public law rules of the host state,⁵ no matter what law is chosen by the parties to be the governing law of the contract - international law or any other a-national law, *i.e.* transnational law. The author notes that internationalization by

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way of choice of international law is aimed at preserving the effect of the principle of *pacta sunt servanda* (p. 55). Again the argument about the principle goes circular.

The author is neither a dualist nor a monist in respect of the application of international law to state contracts but he seems to find even in the dualist notion, along the lines of the Kelsenian view of international law, “an important structural premise of the vertical applicability of international law” (p. 69). There he finds his springboard for plunging into a pool of his reconceptualisation of the applicability of international law to state contracts which is neither dualistic nor monistic. In his view municipal sovereignty provides that structural premise for the vertical applicability of international law to individual rights of investors (equated with interests) created by contractual commitments (p. 70). He finds such a relationship between international law and municipal law not in the monist or dualist theory of international law but in a half-way house, *i.e.* co-ordination of relationship between the two legal orders in which international law conditions the applicability of municipal law. This advocates the controlling authority of international law over municipal law contrary to the well-known Serbian *dictum* that state contracts are based on the municipal law of some country.\(^6\) Although the author does not say explicitly, as Dupuy in the *Texaco* case or Weil in his writings as cited, whether such controlling authority of international law elevates a contractual obligation as such to an international law obligation, he does not seem to exclude the possibility clearly (p. 72). In order to give such an effect to a contractual obligation, he has rushed to take a different tack though, *i.e.* the “umbrella clause” of a relevant investment treaty as a regime *lex specialis*. It is not denied that such a position is possible in limited circumstances as developed in recent arbitral practice and case law but the author’s idea of automatic co-ordinating role of international law for applicable municipal law (being the sole applicable law) cannot stand firm unless one can explain (to which he seems to have paid little attention) that the State, being a party to a contract with a foreign investor and at the same time being a subject of international law, automatically submits its conduct to be scrutinised by the standards of international law such as the international minimum standard.

It is now a well-established view that a state enters into a contract with a private entity in two capacities – *i.e.* (i) as a contracting party and (ii) as the sovereign authority, and they are not mutually exclusive but run concurrently. If the contracting private entity is a foreign one, international law could be used as a yardstick to measure the state’s conduct when it turns out to be delictual, but not for mere breach of contract. Thus, for invoking state responsibility a mere breach of contract is not enough and there must be something extra to it as the author also recognises (p. 76). However, in that context that role of international law is external to the contract and may not be understood in the sense of “co-ordination” or “control” within the precincts of the contract itself. It is noteworthy that there have been some efforts by others in internalizing such role of international law in the contract itself by placing the contract automatically, no matter what other law the parties have agreed, in the international legal order making it equivalent to treaty.\(^7\)

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\(^6\) Serbian Loans Case, PCIJ Series A No. 20 (1929) 5.

At the end of Chapter 3, the author draws attention to treaty arbitration, *i.e.* ICSID, and international commercial arbitration for the relevance and application of international law (pp. 85-96). In the case of the former he asserts that international law is meant to apply as a matter of inherent competence of an ICSID tribunal as an international mechanism created by the ICSID Convention (1965) even though the parties exclusively choose municipal law according to the first sentence of Article 42(1) of the ICSID Convention. Although from the theoretical perspective the same cannot be said in the context of international commercial arbitration based on the parties' contract, the author derives support for his view to the contrary from the existing arbitral practice where arbitral tribunals relied on the initial premise of internationalization of contracts such as in the *Texaco* award. Essentially, what the author intends to say that the structural arrangement of arbitral tribunals, *i.e.* whether treaty-based or contract-based, does not matter much about the application of international law despite the disputing parties' exclusive choice of municipal law, but what the author does not say clearly whether the scope, nature or the *modus operandi* of the application of international law will be the same or different in both cases. It is not only a theoretical question but also practical.

The author examines certain jurisdictional and enforcement issues in the context of the New York Convention 1958 and the ICSID Convention in chapter 4. Here the author examines the issues of consent to arbitration, the role of the *lex fori* to determine the validity of consent and also the overbearing trend in state contract arbitral awards towards the internationalization of procedure determining those matters in which he finds the autonomy of the will of the parties expressed in their contract as the driving force. Although the author has not explicitly said and explored, it should be mentioned, however, that all these point to the contractual theory of arbitration as the underlying current. At least, state contract arbitration tribunals apparently embrace the contractual theory increasingly rather than the jurisdictional theory of arbitration in procedural matters, the *lex fori* is not neglected completely, however, while in need. The reason for this is that the international procedural law of arbitration is not a self-contained body of law and often needs to be supplemented by the *lex fori* principles, but then again to be modulated by the spirit of the international nature of arbitration. While discussing the recognition and enforcement of foreign arbitral awards under the New York Convention, the author observes: “(t)he main advantage of investment arbitration is precisely the conception of it as a hybrid: international for the purpose of authority; municipal (or ‘foreign’) for the purpose of enforceability” (p. 114). In the context of jurisdiction and enforcement under the ICSID Convention the author makes an extensive review of certain pertinent issues concerning consent to ICSID jurisdiction, the notion of investment, contractual and investment treaty jurisdiction. The author also draws distinctions between the New York and the ICSID Conventions with respect to enforcement measures, process and outcomes. The author has done an admirable job in taking pains to examine the complexities of the issues and making some interesting insights into them and convincing suggestions.

Chapters 5 and 6 have been dedicated to some substantive aspects of state contracts such as expropriation, fair and equitable treatment, acquired rights, compensation and the contractual restriction of public powers under the banner of legitimate expectations. Although the discussion was mainly focused on contract claims in arbitral practice, treaty claims have been explored in their contexts. There is a mixture of both theoretical
and arbitral-practice oriented discussion in this second part of the book maintaining a fine balance between them. The author has explored both customary and conventional international law perspectives in respect of the aforementioned substantive aspects in a measured way. He has explored to some length the implications of umbrella clauses as a vehicle for elevating contract claims into treaty claims. It has to be mentioned that there appears to be currently a growing literature on the aforementioned aspects; the author, however, has provided an engaging balanced treatment of them. As a whole, the author’s insight into arbitral practice and analytical inquiry into it is admirable.

Despite the aforementioned shortcomings, the book represents throughout an admirable undertaking of examining the burning issues of state contracts today in the context of both contract and treaty claims. The author has provided in his discussion analytical and critical insights into those issues in such an engaged manner that makes the book distinctive. Serious scholars of international law (both private and public) with an interest in state contracts and arbitration will find the book enormously valuable.