Public-Private distinction and the dilemma of mandatory laws: an ICSID perspective

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I-Introduction

It appears that, for decades, the approach of legal systems towards private arbitration in public-nature disputes has been characterized by a certain mistrust or suspicion. Initially, this attitude may somehow have been linked to the uncertainty as to the **arbitrability** of these issues, in view of the fact that, in these kinds of disputes the private-based concept of the arbitration is not in compliance with the aim of the laws when public interests are heavily at stake. Arbitrability was accompanied with another challenge in respect of the applicability of public-law nature rules. Arbitration is a mechanism for pursuing a balance between the conflict of parties’ demands, and for achievement to this, arbitrators shall specifically focus on parties’ common benefits to be arbitrated. Deciding the public-law nature issues, but, may require the arbitrator to consider public interests and to apply mandatory rules of law that are in conflict with common demands and expectations of the parties.¹

In international investment arbitration based on ICSID convention, however, in contrast with other international arbitrations, the matter of arbitrability of public-nature disputes is the generally accepted basis of the establishment of the tribunals. In fact the purported aim of the ICSID convention was to build an instrument for resolution of disputes relating to the action of home-state when it is challenged by the private investor stating that the action fails to be in compliance with state’s obligations envisaged in international law or incorporated in bilateral investment treaties. However the matter of extent and form of applicability of mandatory rules of law in these cases remains challenging and controversial particularly due to the unique nature and structure of ICSID as a public-private arbitration center and as an international convention-based institute.

The aim of this article is to resolves the tension that exists between mandatory legal rules and the widespread use of arbitration in investment disputes in the light of ICSID rules and its tribunals’ precedence. To the faith of that aim we would first scrutinize the nature and function of ICSID tribunals and then give an analytical discussion of the manner in which mandatory rules have been applied by relevant ICSID tribunals, converging different related approach we have made a smooth path to explore how the issue of role of mandatory rules in international investment arbitration is situated in international legal environment.

II-ICSID, a public or private international tribunal
It is both possible and useful to distinguish between the public and private\(^2\) character of disputes that are resolved by international means of dispute resolution.\(^3\) However it is not firstly easy to determine under which, public or private, category, cases raised in accordance to ICSID rules are situated. Investment treaty arbitration is usually considered as a type of public law adjudication,\(^4\) both because it is established by a sovereign act of the state and because it is used to resolve regulatory disputes, but this is not persuasive in respect of ICSID arbitration with so many similarities to commercial and private arbitrations, in respect of establishment, procedure, adjudicating and enforcement. So it would be of interesting value to have some practical and theoretical debate to settle on the issue in accordance with ICSID rules and precedence.

**A-private form of adjudication for public law-nature disputes**

Despite the precedence of the ICSID showing that the scope of the review by the tribunals may be extended to the executive, legislative\(^5\) or even judicial actions\(^6\) of the state involved, the framework in which ICSID tribunals are operated could persuade that ICSID is an

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\(^5\) See: Aes Summit Generation limited v the republic of Hungary, (ICSID case no. arb/07/22), (2010) award at para 14.3.1

\(^6\) See: Ata Construction, Industrial and Trading Company v Jordan (ICSID Case No. ARB/08/2)(2011)award at Para 42
in institutionalization of private law–based *form* of dispute resolution\(^7\) through commercial arbitration procedures for adjudication of underlying *substance* of host state actions, that is more appropriately governed by public Law.\(^8\) This, nevertheless, could be true if we take no notice of the new distinction of contract-based as opposed to treaty-based disputes in ICSID arbitrations. Even though in investor-State arbitration, mostly, the state’s act that triggers a dispute is uniquely sovereign in nature,\(^9\) it is not much accurate to come to the conclusion to deny any jurisdiction in respect to the dispute when this condition is not as satisfactory as required to give the tribunal the authority to hear the case, having into account, particularly, many cases in which the explained public-private distinction becomes blurred due to incorporation of an ‘umbrella clause’ in an investment treaty that permits a tribunal to characterize a breach of contract by the state as a violation of the treaty.\(^10\)

**B- Umbrella clause as a challenge to public-private distinction**

There is a distinct class of investment treaty arbitrations in which the dispute itself arises directly from an alleged breach of contract by the state. They involve claims by investors pursuant to ‘*umbrella clauses*’ contained in investment treaties which typically provide for the states parties to ‘respect’, ‘observe’ or ‘abide by’ all of their obligations and commitments to foreign


\(^8\) Kim, Dohyun, the Annulment Committee’s role in multiplying inconsistency in ICSID Arbitration: the need to Move Away from an Annulment based system, New York university law review [vol. 86:242, 242-280,(2011), at 253


\(^{10}\) Van Harten, supra, at 8.
investors. A broad reading of such clauses is that they establish a general, overarching guarantee on the part of the state to any foreign investor that has entered into a specific agreement with the state. On this interpretation, an umbrella clause transforms a breach of contract by the state into an outright violation of the treaty and may enable an investor to bring a treaty claim alongside the causes of action available under the contract. Consequently umbrella clauses introduce a grey area in the classification of arbitration as public or private law.

This obscurity engenders the ICSID tribunals to come in different decisions in interpretation of the clause from different perspectives. Some have taken the approach, which says that the clause gives jurisdiction only when coupled with some other substantive treaty claim. Some others have, on the other hand, decided that the clause internationalizes contract claims by elevating them to a treaty level, and, thereby, gives to ICSID jurisdiction over breach-of-contract claims.

In this line two relevant arbitrations against Pakistan and the Philippines, respectively, under separate investment treaties, initiated by the same Swiss investor SGS Société Générale de Surveillance S.A could be outstanding examples of these two opposing approaches by ICSID

13 Mills, supra, at 479
In SGS v Pakistan, SGS the tribunal declined to assert jurisdiction, finding that the wording of the umbrella clause to obligate Pakistan to ‘constantly guarantee the observance’ of its commitments to investors was not sufficiently clear and specific to convert Pakistan’s contractual duties into treaty obligations. This was to avoid a clash between and to maintain the autonomies of the worlds of treaty and contract by drawing on a distinction between sovereign and private acts of the state. In doing so, the tribunal indirectly preserved the integrity of treaty arbitration as ‘public law’ adjudicative system by limiting the ability of investors to bring treaty claims based on breach of contract. In SGS v Philippines another tribunal rejected, in strong language, the reasoning of the award in SGS v Pakistan, stating that the applicable umbrella clause made it a violation of the treaty for the Philippines to breach a binding contractual commitment to investors. In tribunal’s view the umbrella clause allowed it to rule on a claim that the home-state had not performed its contractual obligations, although the scope and content of those obligations remained subject to the contract.

These apparently contradictory conclusions, however, shall not prompt us to ignore the relevance given in both decision to underlying public-private concern with respect to an interpretation of umbrella clause. The concerns raised by the first tribunal are some kinds of real ones in investment arbitration that neglecting them would give rise to an extended use of ICSID tribunals in contrast with primary intentions of the member states to use it as an adjudicating instrument for organizing regulatory actions of the states. In the other side disregarding umbrella clause may

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17 Wendlandt, supra, at 557. For similar conclusion see: Lanco v. Argentina,(ICSID Case No. ARB/97/6)award at para. 2. and Vivendi v. Argentina,(ICSID Case No. ARB/97/3) at para11.
deprive investors of a basic treaty-based rights to maintain their contractual rights against irrational sovereign actions by the home state. Therefore, the obligations imposed by umbrella clauses have to be conceived of in terms of a regulatory duty of the state to observe its obligations in general, rather than an all-encompassing obligation to respect every single commitment entered into by the state in a private capacity. Consequently, the jurisdiction of the ICSID tribunals shall be limited to the extent that the protection of investors against this obligation is required to be satisfied. This reasoning would respect the distinction between the realm of contract and treaty obligations of states and avoid unnecessary and gratuitous extension of the ICSID jurisdiction in international sphere.\textsuperscript{18}

III. Contract-based v. treaty-based paradigm and application of mandatory laws

The conflicting conclusions in respect of application of mandatory laws in, rather, analogous ICSID cases have induced some authors to propose different and somewhat opposing arguments in respect of investment claims.\textsuperscript{19} With analyzing the nature and function of ICSID arbitration system and the concept of mandatory laws in international investment law, having taken note of ICSID convention texts, we provided a contract v treaty based distinction to justify the latent structured approaches thought to be in conflict. In our understanding wrongly applying purported mandatory rules would be as much a problem as wrongly not applying\textsuperscript{20} since it may either be in

\textsuperscript{18} Van Harten, supra, at 27. See also: Joy Mining Machinery Limited v Egypt (ICSID Case No. ARB/03/11) (2004) Award at para.81
\textsuperscript{19} To avoid these conflicts some authors suggested that parties should agree on rules of conflict. See: Bishop, R. Doak & Crawford, James & Reisman, William Michael, Foreign Investment Disputes: Cases, Materials, and Commentary, (2005) at p.236.
\textsuperscript{20} Waincymer, supra, at 29
conflict with parties’ legitimate expectations or demolish national or international policy considerations in international investment environment.

The basis of our paradigm is that contract claims, like other contracts concluded by state in their own private capacity, normally belong to a domestic law ambit, and even though covered by ICSID jurisdiction on the basis of an umbrella clause, will remain quite clearly a matter of public law and shall be considered on the light of municipal mandatory rules. Their public-nature character wouldn’t be altered by a mere fact that the dispute is originating in a contract between an investor and a state entity and the shadow of ICSID conventions text makes the role of domestic mandatory laws as a primary source of adjudicating of the disputes relating to the obligations intertwined with the sovereign authority of the state. On the other hand treaty-based dispute lies in international sphere and makes the presence of international mandatory rule as necessary as required to the realm of justice in international law.

This scheme is not derived, completely, from but is in conformity with the principal provisions of the ICSID convention in respect to determination of applicable law as incorporated in Article 42(1). It consists of two sentences, The first gives the parties full autonomy in regard to the selection of the law applicable to the merits of their dispute and the second one requires an ICSID arbitral tribunal, in the absence of party agreement on applicable law, to apply the law of the “State party to the dispute (including its rules on the conflict of laws) and such rules of international law as may be applicable.” In fact to reach this understanding, it is required first to

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put different parts of investment arbitration puzzle in a consistent and coherent system of interpretation and conflict of laws rules, in which the policy considerations have an essential role. We shall, then, go through to take the scheme that brings private costs in line with social costs, and may increase social welfare and public interest in investment law, as in the same time respect for the legitimate expectations of the parties is satisfied. It let us to conceive arbitration in a new world of investment through a functional and structured way on the basis of a simple and traditional rule of distinction.

A- Conflict of mandatory laws in contract-based disputes under ICSID arbitration

For a range of reasons, determining the appropriate role of mandatory rules in international investment arbitration is complex. This is in one hand because it raises conflicts between the promotion of party autonomy and the protection of state interests\(^23\) Greenawalt, 2007, p.104) and on the other hand since there are questions as to which laws should have greatest influence among the domestic and international rules of states or a group of states that may have a legal and/or commercial interest in an international dispute.

Generally there are some rules in international law, including the notions of transnational public policy, to resolve these conflicts, but the system in ICSID is a unique one in which the rules may differ according to the contract or treaty based nature of the dispute. In a contract-based investment arbitration in which, for example, an investor faced claims of breach by a State, the

investor might raise as an exculpatory defense the obligation to comply with the mandatory laws of his home State, as applicable mandatory rules on their contractual relations. So what is generally said that the host State may not invoke as an exculpatory device a self-proclaimed mandatory rule of law of that State is not commonly true in respect of the contract-based disputes. In these claims, unless the parties have agreed otherwise, arbitral tribunals would as a rule continue to apply the applicable domestic law in the first instance, resorting to international law only as needed to supplement or correct the domestic law.

This approach was explained in Autopista award in which the tribunal stated that “[w]hatever the extent of the role that international law plays under Article 42(1) … there is no reason in this case, especially considering that it is a contract and not a treaty arbitration, to go beyond the corrective and supplemental functions of international law.” This means that the action by the host state could be reviewed by the tribunal in case that such action is so arbitrary that contradicts with fundamental obligations of the that state in accordance to international law. In this case international mandatory law takes its secondary role of revision of domestic measures. As professor Schreuer emphasized “{domestic} rules are checked by the application of international standards such as denial of justice and discriminatory taking of property or the arbitrary repudiation of the contractual undertaking”. In fact the role of international law is limited to the case where there are lacunae in domestic law or there is a conflict with

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24 Bjorklund, supra at p.263.
international law in that case should international law be applied complimentarily,\textsuperscript{28} as some recent cases suggest that corruption\textsuperscript{29}, as a violation of \textit{ordre public international}\textsuperscript{30}, and fraud, as a general principle of law, must be considered in determination of applicable law.\textsuperscript{31}

Another view in respect of the contract-based dispute is to apply international mandatory laws not in a supplementary capacity but as a primary rules to the extent that contractual obligations of the host state can be defined as act of sovereign as incorporated in the bilateral treaty. This is bases on the understanding that a basic general distinction can be made between commercial aspects of a dispute and other aspects involving the existence of some form of State interference with the operation of the contract involved.\textsuperscript{32} One comprehensible demonstration of this approach would be the case of \textit{Wena Hotels} arbitration\textsuperscript{33} in which the tribunal concluded that the host state is responsible for failure to remedy the illegal conducts of its own company since the


\textsuperscript{30} See:RSM Production Corporation v. Government of Granada (ARB/05/14), Lucchetti Enterprises, S.A. and Lucchetti Peru, S.A. v. Republic of Peru (ARB/03/4), SGS Société Générale de Surveillance S.A. v. Republic of the Philippines (ARB/02/6), F-W Oil Interests, Inc. v. Republic of Trinidad and Tobago (Case No. ARB/01/14), World Duty Free Company Ltd. v. Republic of Kenya (ARB/00/7)

\textsuperscript{31} See: World Duty Free Company Ltd v. Republic of Kenya, ICSID.

\textsuperscript{32} See: Joy Mining Machinery Limited v Egypt (ICSID Case No. ARB/03/11) (2004)award at para.72

\textsuperscript{33} Wena Hotels Ltd v Egypt (2000), 41 ILM 896. See also Compañía de Aguas del Aconquija SA & Vivendi Universal v Argentine Republic (Annulment) (2002), 6 ICSID Rep 340, para 95-6.
that failure violated state’s obligations under the treaty, including its duties to ensure fair and equitable treatment, as well as full protection and security, for investors.34

B- Conflict of mandatory laws in treaty-based disputes under ICSID arbitration

Investment treaty arbitrations are, in contrast with contract-based disputes, typically governed by international law, whether that law takes the form of treaty terms or customary international law. In Siemens AG v Argentine Republic the tribunal rejected the notion that international law was referred to in the provision merely “as a corrective to municipal law or as a filler of lacunae in that law.”35 It went on to point out that “the Tribunal’s inquiry is governed by the {ICSID} Convention, by the [BIT] and by applicable international law.”36 However in case of conflict between different international mandatory rules, treaty provisions, as lex specialis, would trump other conflicting sources of international mandatory laws so long as and to the extent that those provisions will not be in violation of a jus cogens norm.37 This rule of prevalence was recently emphasized in AES v Hungary in which the tribunal recognizing the ”{Energy Charter Treaty}ECT{as applicable law}”, limiting consideration of “{European comunity}EC {mandatory rules of }law … {as} only a {matter of fact}element to be considered … when

34 For review of State’s liability for the conduct of its instrumentalities on the basis of an investment treaty see: Emmanuel Gaillard & Jennifer Younan, 2008, State Entities in International Arbitration, JURIS publishing.
37 Bjorklund, supra, at p.233
determining the “rationality,” “reasonableness,” “arbitrariness” and “transparency” of the {state act}.”

Nonetheless, this doesn’t mean that there is no role recognized for municipal mandatory laws in treaty-based disputes. Municipal and international law have a complementary role and an interpretive\textsuperscript{39} or interactive function in adjudicating of the dispute.\textsuperscript{40} In practice the tribunals usually recognize and apply host state mandatory laws in respect of certain questions and substantive aspects of the disputes. The reasoning may cover different aspects in which the application of domestic mandatory laws are necessitated by nature or aim of the rule or by virtue of treaties’ provisions such as whether or not a covered investment was made in accordance with local law.\textsuperscript{41} Mandatory rules may, moreover, be at issue when States seek to raise defenses or counterclaims to claimants’ cases. They may also appear in the arguments respecting quantum as States seek to set off amounts they owe as damages by allegations of failure by the claimants to comply with particular laws. Furthermore, municipal law may be important in that an egregious departure from municipal law could have some bearing on whether a State has violated international law. For example, a denial of justice may result when a municipal court egregiously


\textsuperscript{39} Those authors that emphasized to see the standard of treatment in international investment law from the perspective of a host state with a presumption that states have the right to regulate freely in their territory, and thus investors face a natural degree of regulatory risk’ focus on this interpretative role of domestic law in treaty obligations. See: Mills, supra, at 492. & Schill, Stephan W., International Investment Law and Comparative Public Law, Oxford University Press ( 2010) at 272.

\textsuperscript{40} See, International Thunderbird Gaming Corp. v. United Mexican States, UNCITRAL, (2006)

\textsuperscript{41} Reed, Lucy & Paulsson, Jan & Blackaby, Nigel & Rawding, Nigel, Guide to ICSID arbitration, Kluwer Law International.(2010), at 72.
departs from municipal law in its decision making.\textsuperscript{42} So in these cases the mandatory rules of host state takes an incidental, but rather important, role in substantive aspects of the disputes. Moreover even though international mandatory laws must prevail in the event of a direct conflict with municipal mandatory laws, but many times it will be open to the tribunal to interpret the international obligations, particularly when the national treatment is raised as an applicable standard\textsuperscript{43}, and rules in such a manner that it is consistent with the municipal obligation. Municipal law also plays a role in the consent to arbitration. Many investment treaties provide that investments be made “in accordance with the laws of the host State,” or the like.\textsuperscript{44} The decisions in both \textit{CMS Gas Transmission}\textsuperscript{45} and the \textit{MTD}\textsuperscript{46} cases in which the simultaneous application of domestic and international law were emphasized don’t contradict with the proposed distinction mechanism. In fact as stated before in both cases of contract and treaty based disputes national and international mandatory rules of law have a role, but the matter is in each case, which would be prevalent on the other one.

\textbf{V. Conclusion}

There is a genuine concern for the harm done to the public welfare by the international investment regime, as currently structured, especially its extending jurisdiction to cover both any related rather than relevant sovereign act of the host state and state’s act performed in its private capacity. It is, now, the time to have the public-private distinction as clear and specific as to

\textsuperscript{42} See, Mondev Int’l Ltd. v. United States of American, ICSID, (ARB(AF)/99/2) 133-38 (2002)
\textsuperscript{43} See: ALPHA Projektholding GMBH V. Ukraine icsid Case No. ARB/07/16(2010)at para.425
\textsuperscript{44} See: Fraport AG Frankfurt Airport Services Worldwide v. Republic of the Philippines, ICSID No.ARB/03/25, 396-401 (2007).
\textsuperscript{46} MTD Equity Sdn Bhd v. Republic of Chile, ad hoc committee(2007), at para. 72.
safeguard legitimate expectations of the host state particularly in respect of application of relevant mandatory rules of law and jurisdiction in ICSID arbitration. The basic principle in investment law is that states have a fundamental right to regulate on behalf of the public welfare and this right must not be subordinated to the interests of investors where the right to regulate is exercised in good faith for a legitimate purpose and not arbitrary or in contrast with its international obligations. In this line ICSID has been established, as a supplementary means to general system of adjudication in international sphere, to give the investors the right of access to an independent international authority to adjudicate the dispute when it is claimed by the investors that any of international obligations has been breached by the host state, by misusing its public power.

The private mechanism of adjudicating in ICSID tribunals shall not mislead us to ignore the public nature of the dispute and host state’s capacity in international law to act in the public interest by way of innovative policy-making in response to changing social, economic, and environmental conditions. In this regard, therefore, application of and rules for precedence in mandatory laws shall be justified and in conformity with the legal prevalence or factual significance of host state law, to the extent required, to satisfy its public accountability. This would be satisfied through application of public private distinction principle that is appeared by contract v treaty based paradigm. In one side, in contract-based investment disputes the significance of host state’s public interest would be ensured by prevalence of state’s mandatory rules through its primarily application and in other side treaty-based disputes even though adjudicated firstly in light of international mandatory rules, are governed secondarily in shadow of consideration of host state mandatory laws./