Application of pacta sunt servanda to State Contracts between Investors and Host States and its Implication for International Investment Regime

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I. Introduction

International investment regime\(^1\) consists primarily of international instruments either of nature hard law or soft law. Hard law instruments include various bilateral, regional, and multilateral treaties. Main component of the bilateral treaties is bilateral investment treaty (BIT) among other relevant treaties such as double taxation treaty; North America Free Trade Agreement (NAFTA), ASEAN Comprehensive Investment Treaty, Energy Charter Treaty, and Trilateral Investment Agreement between China, Japan, and Korea exemplify the regional treaty; and the multilateral treaty includes multilateral treaties concluded under the World Trade Organization (WTO) such as Trade-Related Investment Measures (TRIMs), General Agreement on Trade in Services (GATS), and Trade-Related Aspects of Intellectual Property (TRIPS), and conventions regulating dispute resolution such as Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention), and Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention).\(^2\) On the other hand, soft law instruments include the United Nations Conference on Trade and Development (UNCTAD)’s materials including its failed attempt to adopt the UN Code of Conduct on Transnational Corporations; the World Bank (WB)’s Guidelines on the Treatment of Foreign Direct Investment; Organization for Economic Cooperation and Development (OECD)’s relevant guidelines and its attempted Multilateral Agreement on Investment (MAI).\(^3\) Other than these international instruments, customary international law and general principle of law plays not a small role in international investment regime as well. Especially, a number of the United Nation General

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\(^1\) Use of the term “regime” in this paper means “sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors’ expectations converge in a given area of international relations” and which is located somewhere between “system” and “framework,” which was adopted by Jose Alvarez following Robert O. Keohane’s adoption of the definition from Stephen D. Krasner’s treatise. See Jose E. Alvarez, The Public International Law Regime Governing International Investment fn. 30 at 25 (2009).

\(^2\) See generally, Alvarez, id. 27-30 (2009).

\(^3\) Id.; see also Jeffrey Dunoff et al., International Law: Norms, Actors, Process 93-105 (3d ed. 2010).
Assembly (UNGA)’s resolutions\(^4\) on permanent sovereignty over natural resources and the Charter of the Economic Rights and Duties of States (CERDS) have significant implications in this sense.

Contrary to this global concern on the international investment regime, or perhaps due to the proliferation of international instruments adopted by various international actors, the regime has been under a heated debate over its legitimacy.\(^5\) Criticism on the legitimacy of the international investment regime is heavily based on the privatization of the regime\(^6\): individual and *ad hoc* private arbitrators, rather than permanent inter-governmental institutions, have been conferred mandate to decide disputes between investors and host states. Especially the arbitrators have dealt with the host states’ exercise of regulatory measures being faced with economic crises, basing their judgments on individualized interpretation and application of applicable laws. Whether the arbitrators of private nature could properly reflect public policy concerns has been intensely debated.\(^7\) Moreover, the privatization has an implication even beyond the private actor’s juridical power over sovereign acts of state in that they, though controversial, affect international law-making by establishing case-law through individualized arbitrations.\(^8\) Given the international investment regime’s unique nature in which non-state actors, i.e. foreign investors, enjoy strong protection against host states’ domestic policy change, private investors’ influence on the international law-making may well place individual on the equal footing with state as the subject of international law in the area of international investment regime. This is more true when states and investors are parties to contracts where individual is without support of its own state by concluding an investment treaty. Thus, private arbitrators may promote the status of private actors within international law by affecting the international law-making through their individualized choice and application of relevant international law.\(^9\)

This paper will suggest caution against private arbitrators’ individualized influence on

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\(^4\) Whether these resolutions codify customary international law on international investment is controversial. See Dunoff supra note 2, 74-92.

\(^5\) With regard to criticism against the current international investment regime, see generally, Alvarez, supra note 1, 75-93.


\(^7\) Alvarez, id.

\(^8\) Id. 75-76.

\(^9\) As Harten mentioned, the private arbitrators, without tenure, may well be biased by their own interests that would be affected by the number of cases and be inclined to grant awards in favor of investors. See Harten, supra note 6, 5-6.
international law-making especially through arbitrations on disputes over contracts between host states and investors in which the principle of *pacta sunt servanda* has played a significant role. Since the arbitrators’ alleged bias towards investors may lead to unfair decisions against host states, arbitration awards rendered by private arbitrators should be scrutinized thoroughly through the lens of legal doctrine of sources of international law.

II. Hybrid Nature of Contract between Host State and Investor

A contract on foreign investment concluded between a host state and an investor has been titled with different names: concession agreement, economic development agreement, state contract, etc. Among others, the term “state contract” seems to have been used by majority of scholars and international institutions. Likewise various views exist on its name, the state contract has been debated over for its complicated legal nature. This is because the state contract features not only commercial nature as it deals with private investment, but also public nature as it is related to a host state’s exercise of sovereign power, i.e. regulatory measures. This “hybrid nature” of the state contract has gained keen attention from field of international investment. Whether international law may be applicable to a breach of the state contract is of primary concern among the scholastic debate over the nature of the state contract.

A. State Contract

According to UNCTAD, the state contract means “a contract made between the State, or an entity of the State, which for present purpose, may be defined as any organization created by a statute within a State that is given a control over an economic activity, and a foreign national or a legal person of foreign nationality.” This is quite a broad definition, focusing on natures of each party to the contract. From the traditional form of concession agreements by which the host state grants certain rights to explore and exploit natural

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10 See generally Jan Ole Voss, The Impact of Investment Treaties on Contracts between Host States and Foreign Investors 15-25 (2011).
11 Id. fn. 2, 15.
12 Id. 16-17.
13 Id. 17.
resources to modern forms of contract such as modern style concession agreements, production sharing agreements, management agreements, technical assistance agreements, service contracts, turnkey contracts, joint venture agreements, licensing and transfer of technology agreements, and a few number of build, operate and transfer agreements (BOT agreements), various kinds of contracts between host states and investors consist of the state contracts.\textsuperscript{16}

The main differences between the traditional form of state contract and the modern forms of state contract lie on shift of ownership from the host state to investors, duration of the contract, payment rate or mechanism, or actual parties to the contract.\textsuperscript{17} Unlike the traditional form, the modern style state contracts do not transfer the ownership of natural resources or exploited materials in general.\textsuperscript{18} Rather, the host states own the ownership and control of the operation of investments with the modern contracts. The duration of a contract has been significantly shortened, while the rate of payment by investors to the host states for the operation of investments has been impressively heightened and the method diversified.\textsuperscript{19} Lastly, the adversaries of the investors have changed from the government of the host states to government agencies or state-owned entities.\textsuperscript{20} These changes from old to new types of state contracts demonstrate shifting power from the investors or home states of the investors culminated in the colonial era to the host states to a certain degree.\textsuperscript{21}

Still, however, the unique feature of the state contract remains unchanged: hybrid of public and private nature of the contract.\textsuperscript{22} It is of nature public in the sense that sovereign state is involved as a party to the contract, often dealing with subject matters related to public interests,\textsuperscript{23} and thus containing provisions connected to host states’ regulatory measures, i.e. exercise of sovereign power.\textsuperscript{24} On the other hand, the sovereign state better or not appears to be mere one party to a contract to which private investors also participates as an adversary.\textsuperscript{25} The public nature of the state contract leads to a need for regulating it by public law which

\textsuperscript{16} See generally, Voss, supra note 10, 17-25.
\textsuperscript{17} Id. 24
\textsuperscript{18} Id.
\textsuperscript{19} Id.
\textsuperscript{20} Id. 25.
\textsuperscript{21} M. Sornarajah, The Settlement of Foreign Investment Disputes 223 (2000).
\textsuperscript{22} Voss, supra note 10, 17.
\textsuperscript{23} Such as infrastructure projects, natural resources exploration and exploitations.
\textsuperscript{24} Voss, supra note 10, 16.
may well reflect public policy concern through restricting self-indulgent implementation of the contract. On the contrary, the private nature contained in the state contract requires protection and assurance of expectations of both parties through fair legal system based on free will of the parties exemplified by the principle of *pacta sunt servanda* and appropriate compensation when one party breaches the promise.\(^{26}\) Tension exists between the two natures reside in the concept of state contract, since the host state is inclined to emphasize the public nature so as to restrict the execution of the contract whenever its domestic circumstance needs modification of economic regulations in ways hostile to the investors, while the investors are keen to protect their legitimate expectations at least by adequate compensation regardless of the host state’s political situation.\(^{27}\) In light of this mixed feature of the state contract, M. Sornarajah’s definition seems to be more suitable: “[state contract] as a contract made between a state or a state entity vested with monopolistic control of a sector of a state’s economy and a foreign entity entering that state with the intent of establishing a long term business relationship with the state or the state entity in that economic sector.”\(^{28}\)

**B. Debate over “Internationalization” of State Contract: Policy Ground for the Internationalization**

The hybrid nature of the state contract and foreign investors’ need for stable protection of their interests without being interfered by unilateral change of law or policy to the detriment of the investors’ legitimate expectations by a host state gave rise to various attempts by arbitrators and scholars to externalize an applicable law and governing jurisdiction from the host state’s domestic forum.\(^{29}\) The arbitrators and scholars who were mainly from developed countries tried to adopt the theory of “internationalization”\(^{30}\) of the state contract as the governing principle, by which to apply laws other than the domestic law of the host state whether it is international law or new type of law, e.g. *lex mercatoria*.\(^{31}\) The internationalization of the state contract has been treated as the core basis of the protection of foreign investments,\(^{32}\) being supported by policy and legal grounds.\(^{33}\)

\(^{26}\) See Voss, supra note 10, 17.

\(^{27}\) Sornarajah, supra note 25, 3.

\(^{28}\) Id. cited in Voss supra note 10, 16.


\(^{30}\) The term “internationalization” of a state contract is said to be systematized by F. A. Mann by his articles. See for example, F. A. Mann, The Proper Law of Contracts Concluded by International Persons, 35 British Yearbook of International Law 34, 43-56, reprinted in F. A. Mann, Studies in International Law (1973), cited in Voss, supra note 10, fn. 61, 25.

\(^{31}\) Sornarajah, supra note 29, 242.

\(^{32}\) Id. 223, cited in Voss, supra note 10, 26.
As to the policy ground, exponents and proponents of the internationalization of the state contract argued that it is unfair to apply a law of a host state to the contract to which the state is one party so that an impartial legal system is needed to regulate implementation of the contract by both parties, especially when the host state is a developing state which allegedly more tends to have unstable political and economic situations with unsophisticated legal system. In connection with this consideration, the advocates emphasized that the application of the fair law external from the host state’s domestic legal system would promote foreign investments, which are to be operated in the territory of the host state under its jurisdiction, by ensuring the investors’ legitimate expectations from the contracts with the host state. A need for regulation of the implementation of the contracts by neutral arbitrators is in the same line with this argument. The incorporation of neutrality into the legal system governing the state contract seems to be self-evident in certain way. However, this policy consideration does not appear to be as fair as it implies to be in the sense that the state contract already puts thumb on the scale of the investors and the proponents of the internationalization theory do not argue the application of the theory to the state contract with developed countries which is arguably always subject to the host states’ law.

C. Legal Grounds for the Internationalization of the State Contract

The theory of the internationalization also has two main legal grounds which are particularly linked to stabilization clause, arbitration clause, or choice-of-law clause all of which more or less common to the state contracts. First legal ground is derived from the famous maxim that “no state can avoid its international obligations by invoking its own or, indeed, any municipal law.” Thus, a state cannot rely on its domestic law to immunize its violation of international obligations. This maxim was clearly codified by the United Nations International Law Commission (ILC) in Art. 32 of the Draft articles on Responsibility of States for Internationally Wrongful Acts (ARSIWA), as was it

33 See generally Sornarajah, supra note 29, 224-257; Voss, supra note 10, 25-50.
34 Sornarajah, supra note 29, 225-226.
35 Id. 223.
36 Id. 249.
37 Id. 225.
38 See M Sornarajah, The International Law on Foreign Investment 281-289 (2010).
39 Mann, supra note 30, 228.
40 “The responsible State may not rely on the provisions of its internal law as justification for failure to comply with its obligations under this Part.”
incorporated into Art. 27 of the Vienna Convention on the Law of Treaties (VCLT). The stabilization clause appears to be in line with this legal ground in that it aims to ensure stability in a host state’s regulation of foreign investments through prohibiting unilateral changes of domestic legislations by the host state to excuse its breach of obligations arising from the state contract. For example, Art. 17 of the 1948 Concession Agreement involved in the arbitration between Kuwait and American Independent Oil Company in 1982 states that: “The Shaikh shall not by general or special legislation or by administrative measures or by any other act whatever annul this Agreement except as provided in Article 11. No alteration shall be made in terms of this Agreement by either the Shaikh or the Company except in the event of the Shaikh and the Company jointly agreeing that it is desirable in the interests of both parties to make certain alterations, deletions or additions to this Agreement.” However, whether the obligation under the state contract is of nature international should not be taken for granted. F. A. Mann argues the obligation’s international character from the state contract’s similarity to international treaty between international persons. According to his argument, a cross-border contract between a host state and foreign investors creates the same kind of international obligation as a cross-border treaty between states generates international obligation of which breach is not excused by reliance on a responsible state’s internal law. But, his logic leaps around in that there is no universal treaty or custom established conferring such effect on the contract between a state, i.e. international person, and private investors who are not yet treated as international person. Mann’s theory is radical in this sense, putting too much emphasis on the practical need for the protection of the foreign investors even almost ignoring absence of such a rule in public international law that gives international nature to the obligation under the state contract. As discussed below, such a rule is hardly said to be established so far.

The other legal ground is based on each party’s free will to decide applicable law and jurisdiction under which to regulate the implementation of the contract, i.e. the principle of

41 “A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.”
42 Sornarajah, supra note 38, 281.
44 Mann, supra note 30, 43-44.
45 Id.
46 Id.
party autonomy under private international law.\textsuperscript{47} First of all, if all the party agrees they can choose whatever laws as applicable to implementation of a contract, according to the principle.\textsuperscript{48} Thus, foreign investors can set neutral, if not hierarchical, law as the applicable law which is not affected by a host state’s discretionary change of its legal system crucial to operation of their investments.\textsuperscript{49} International law or general principles of law (recognized by civilized nations)\textsuperscript{50} are of those commonly chosen as the applicable law, and totally a new type of law such as \textit{lex mercatoria} has been adopted as one of them sometimes.\textsuperscript{51} The main problem with this legal ground is however, quite similar to that of the first ground: there has been no such international law established regulating a contract between a state and investors to grant private foreign entities vast rights of sovereign nature which used to be governed by public law. Unless firmly backed by clear sources of international law, resorting to international law is as to make an echo of no return.\textsuperscript{52} Asserting the new type of law other than already existing jurisprudence of international law or general principles of law may be seen as an attempt to bypass this problem.\textsuperscript{53} Nonetheless its creativeness, it does not solve the problem because of differences between the state contract and ordinary transnational commercial contracts.\textsuperscript{54} Above all, unlike the ordinary commercial contracts, the state contract includes a sovereign state as a party, as has been constantly emphasized in this paper so far. The status of the state is different from a private investor whose status as an international person has not been established yet. Especially, the state contracts regulate the state’s exercise of sovereign rights, i.e. \textit{acta jure imperii}. This is not envisaged by the commercial contracts which mainly deal with commercial transactions by private entities. Moreover, the state contracts are not more closely related to a host state’s legal system than that of any other states’. For the commercial contracts various legal systems from several

\textsuperscript{47} Sornarajah, supra note 38, 284.
\textsuperscript{48} Id. However, two approaches in regard of the party autonomy principle have been debating over kinds of law that can be chosen as an applicable law. Traditional view argues only \textit{lex fori}, i.e. domestic law of forum states, as the applicable law parties can choose, but modern view emerged as arguing applicability of international law as well. See generally Voss, supra note 10, 34-37.
\textsuperscript{49} Sornarajah, supra note 38, 285.
\textsuperscript{50} Sometimes “recognized by civilized nations” is omitted, but whether or not the phrase is included in the state contract, arbitrators seem to have almost always interpreted it in line with the formal source articulated in Art. 38(1)(c) of the Statute of the International Court of Justice.
\textsuperscript{51} Sornarajah, supra note 29, 242-245.
\textsuperscript{52} This criticism is supported by numerous judgments of the International Court of Justice (ICJ), international arbitration awards, certain common law jurisprudence such as Serbian Loans case before the PCIJ. See Sornarajah, supra note 38, 285-286.
\textsuperscript{53} Sornarajah, supra note 29, 248-249.
\textsuperscript{54} These differences are highly related to the hybrid nature of the state contracts.
states may be involved depending on nationalities of the parties and a territory where the transactions occur. However, foreign investments under the state contracts operate in the territory of the host state; thus, law of the host state is an almost only relevant law while other states’ legal systems have nothing to do with the operation of the investments.\(^5\) Second of all, under the modern approach on the principle of the party autonomy, the parties to the state contract may choose whatever jurisdiction they want to submit disputes over the implementation of the contract between them.\(^6\) This is linked to the arbitration clause, by which the investors try to resort to neutral international arbitral tribunal outside of the host state’s legal system.\(^7\) Notwithstanding general practice of survival of the arbitration clause in the commercial contracts after termination of the contracts however, it is not clear whether the arbitration clause in the state contracts can survive the termination of the contracts by the host state’s legislative change.\(^8\) Even though private arbitrators of *ad hoc* arbitral tribunals seem to have recognized the survival of the arbitration clause once the clause establishes the tribunals, regardless of the character of the contracts or of existence of reference to treaties such as the ICSID in the arbitration clause,\(^9\) the fact that those arbitrations often proceeded unilaterally without appearance of the host states offsets the arbitrators’ support on the survival of the arbitration clause in the state contracts.\(^10\)

To sum up, the enigma of the hybrid nature of the state contract remains unsolved, while the debate over the internationalization of the state contract, which was invented to overcome the obstacle in favor of the protection of the foreign investors, has not been settled yet. Rather, the introduction of the theory of the internationalization by private arbitrators and scholars has made it quite blurred the distinction between public and private international law, one of whose primary implications lies on the different status of private entities compared to that of sovereign states. Among other factors, the principle of *pacta sunt servanda* is in the eye of the storm in the sense that the two legal grounds of the internationalization theory are largely based on the legal effect of consent of a host state to conferring on foreign investors certain rights by which they can hold the state responsible

\(^{5}\) Sornarajah, supra note 38, 285-286.
\(^{6}\) Id. 286-288.
\(^{7}\) Id. 286; Marboe, supra note 14, para. 13.
\(^{8}\) Sornarajah, supra note 38, 287.
\(^{9}\) Arbitral award on Liamco case is in line with this approach.
\(^{10}\) Sornarajah, supra note 38, 288.
without resorting to protection of their home states. Thus, it is important to critically scrutinize what is expected from the principle of pacta sunt servanda by both proponents and critics of the internationalization theory and which role it should take, to find out sound structure of the law governing the state contract for more effective operation of the international investment regime on the state contract.

III. The Role of pacta sunt servanda in the Implementation of State Contract

As a universally recognized general principle of law, the principle of pacta sunt servanda and closely intertwined principles surrounding it such as principle of free consent, of good faith, and estoppel, etc. have been frequently mentioned and applied either explicitly or implicitly as the main legal bases on which to impose international obligations on relevant actors and to hold them responsible for violation of those obligations. However, applicability of the principle to a contract between international person, states, and private entities has not been settled yet, having caused the acute controversy between scholars from developing and developed countries. Notwithstanding the controversy, private arbitrators have applied the principle of pacta sunt servanda to the state contracts in quite a number of cases. However, sound analyses of the legal ground of the application have been hardly seen. The lack of firm theoretical and legal grounds of applying the principle to the state contracts has catalyzed the friction between the actors involved and scholars from both the sides, only to undermine legitimacy of international arbitrations on disputes over implementation of the state contracts and effective enforcement. This Part will verify arguments of the both sides on the role of the pacta sunt servanda principle on the implementation of the state contract, to figure out its desirable role based on the rational legal ground.

A. Pacta sunt servanda Principle’s Multifaceted Positions in Public and Private International Law Spheres

The principle of pacta sunt servanda has long been recognized and applied as part of public international law mainly regulating inter-state relations, even before it was codified in Art. 26 of the VCLT. According to the Art. 26 and the preamble of the VCLT, which emphasizes universal recognition of the principles of free consent, of good faith, and of the

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62 Yackee, id. 1570-1572.
63 Every treaty in force is binding upon the parties to it and must be performed by them in good faith.
pacta sunt servanda, it has been firmly established as general principles of law applies to international treaty between states being closely connected to the other two principles. In the meantime, the principle of pacta sunt servanda, generally recognized by domestic legal systems, has also been closely attached to private international law governing transnational commercial transactions between private entities. One of the core principles of private international law, the party autonomy principle, does not make any meaningful effect unless legally binding force is conferred to a contract to which both parties has given their consents by supplementary legal principle, i.e. pacta sunt servanda. The main differences between the application of the principle in public and private international law spheres lie on the object of the application and the nature of subject matter. While in public international law sphere the principle applies to inter-state relationships on the exercise of sovereign acts, the principle primarily applies to relationships between private parties on transnational commercial transactions. This dual position of the principle have been adopted in various ways and developed to multifaceted position by scholars and arbitrators who have endorsed the internationalization theory.

The first way is to apply the principle of pacta sunt servanda from public international law sphere. Under this category, the state contract is basically treated as if it were an international treaty between states both of which are based on the same nature of involving a state’s consent to be bound by the instrument whatever the title would be. Some scholars have argued the concept of “international contract” or “restrained international contract,” relying on the assertion that sovereign states can make any form of a contract of nature international which creates international obligations of the states by exercising their own sovereignty. The famous arbitration award on the case between Saudi Arabia and Arabian American Oil Company (Aramco) in 1958 thus notes that: “The Concession Agreement is thus the fundamental law of the Parties, and the Arbitration Tribunal is bound to recognize its particular importance owing to the fact that it fills a gap in the legal system of Saudi Arabia with regard to the oil industry. The Tribunal holds that the Concession has the nature of a constitution which has the effect of conferring acquired rights on the contracting Parties. By reason of its very sovereignty within its territorial domain, the State Possesses the legal power to grant rights which it forbids itself to withdraw before the end of the Concession, with the reservation of the Clauses of the Concession Agreement relating to its

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65 Voss, supra note 10, 29-30.
revocation. Nothing can prevent a State, in the exercise of its sovereignty, from binding itself irrevocably by the provisions of a concession and from granting to the concessionaire irretractable rights."\textsuperscript{66} Thus, states can freely accord an international personality with which foreign private entities may conclude with the states a contract that imposes the states international obligations same as the ones set by an international treaty.\textsuperscript{67} According to this approach, the state contract itself becomes international law \textit{per se} which is supplemented by the principle of \textit{pacta sunt servanda}.\textsuperscript{68} However, this argument conflicts with essential rules of public international law, therefore hardly acceptable.\textsuperscript{69} To simply put, the “missing link” of legal personality of the private entities cannot be cured by states’ mere “unilateral recognition.”\textsuperscript{70} This is because consent of a state as a source of self-imposed international obligations has always been recognized to presuppose its adversary states or international organizations of which international personalities have long been recognized under public international law.\textsuperscript{71} To change this well settled legal basis and treat the private entities as international persons, substantial supports from states either by treaties or by custom are still needed despite ever enhancing position of individuals in the international community. In the meantime, other scholars take a different approach that the scope of the \textit{pacta sunt servanda} principle covers not only international treaties between international persons but also the state contracts, on the ground that there is no adequate law for regulation of the state contracts.\textsuperscript{72} This is not a sound reason however, in that mere practical need does not ensure a theory’s legal ground. To fill up a legal vacuum by a theory making another legal vacuum on which the theory is grounded does not make any sense.\textsuperscript{73} The concept of the general principles of


\textsuperscript{67} Voss, supra note 10, fn. 77, 29. Topco, and Revere cases are in line with this argument. See id. 30.

\textsuperscript{68} Aramco, supra note 66, 168.

\textsuperscript{69} Voss, supra note 10, 30.

\textsuperscript{70} Id. fn. 83.

\textsuperscript{71} The classic judgment of the world court and treatise clearly support this premise. See Serbian Loans case, cited in Mann, supra note 30, 228. As to the current argument in favor of this position, see Amerasinghe, Local Remedies in International Law 129 (2d ed. 2004), cited in Voss, supra note 10, fn. 84, 30.


\textsuperscript{73} The Amioil award’s statement that a contract should be based on any legal system also implies no discretionary law can be made out of a mere practical need, absent any basis from existing legal system. See Aminoil, 117, cited in Voss, supra note 10, fn. 98, 32.
law, chiefly rooted in the Statute of the ICJ, has been invoked to regulate inter-state relations, and its applicability to the state contract outside of inter-state relations is doubtful, lacking any legal ground other than the practical need.

The second way is to apply the principle of *pacta sunt servanda* from private international law sphere. Some scholars and arbitrators assert that, based on the modern view on the principle of party autonomy under private international law, parties to the state contract may choose public international law, i.e. the *pacta sunt servanda* principle, as an applicable law to the contract. This view gives “unfettered discretion” to the parties in choosing substantive laws to apply to the state contract. The arbitration on the dispute between Sapphire International Petroleums Ltd. and National Iranian Oil Company (Sapphire) adopted this approach as well. However, this approach also has some defects. Above all, there is no such kind of the *pacta sunt servanda* principle in public international law sphere that is applied to relationships between a state and private entities. Thus, even if the choice of public international law is permitted, choosing public international law as an applicable law does not come with applicable substantive rules to the state contracts. Moreover, as the award on Topco correctly points out, although rejected it, no support by any enforcement mechanisms exists unless the arbitration is based on domestic legal system in which the arbitration can be enforced.

The final way is to grant the *pacta sunt servanda* principle a totally new position. Several theories exist under this way. Above all, A. Verdross’ “*lex contractus*” is a classic example. His argument is that the state contract itself constitutes an independent legal system of nature neither municipal nor international: thus, “quasi-public-international.” This theory is based on the ground that free will of both parties to a contract may establish their own legal system by which to regulate its implementation. However, the problem here is that what the theory does is only to have borrowed the *pacta sunt servanda* principle from public international law and placed it on the new strange third land. How this legal

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74 Sornarajah, supra note 29, 226-227.
75 Voss, supra note 10, 36.
77 Voss, supra note 10, 39; Sornarajah, supra note 29, 226.
78 Voss, supra note 10, 36-37; Topco, 432.
79 Mann, supra note 30, 229-230.
81 The *pacta sunt servanda* principle plays a role here as a preceding rule by which to grant binding
system is related to public international law or private international law is not known as is the existence of the place on which the new legal system stands not known either. The theory’s radical feature was criticized in the sense that the lex contractus may well result in even ignoring jus cogens in public international law in its extreme application, whose problem may also impede operation of private international law. Lex mercatoria is other recourse for the application of the pacta sunt servanda principle to the contract between a state and private foreign entities. As a non-national body of law established by the international business community based on its custom and “general principles of law” that are applicable to international commercial transactions, lex mercatoria has been primarily applied to trans-border commercial transactions between private parties. Being grounded on the modern view on the party autonomy principle under private international law, it is basically a choice-of-law rule allowing parties to decide which rule to apply. But the concept is not a mere rule of choice of law in the sense that it also purports to be an independent legal system supplementary to the transnational commercial transactions, to which parties to the transactions may refer. The reason why lex mercatoria adopts its own independent legal system which differs from either domestic law or international law is that first, domestic laws do not always sufficiently reflect normative expectations in international commercial transactions; and second, in international law private entity’s role is significantly restricted. Thus, the concept of lex mercatoria insulates itself from either a host state’s domestic legal system or public international law and places itself on a plane where parties can participate in the creation of applicable law friendly to commercial transaction, including the state contract, whether the party is a state or a private entity. However, its legal nature itself has been under a huge debate, whether it is a legal system or a mere composite of business practices. If it is only a business practice compound, it needs another established

force to the contract.

82 Later he contended the pacta sunt servanda principle and other general principles of law related to a contract as legal sources. Voss supra note 10, 30-31.
83 Mann, supra note 30, 230-231.
84 The term “general principle of law” is used in different meaning from that discussed above. See Abu Dhabi case, 149.
86 Id. para. 20.
87 Sornarajah, supra note 29, 242; Schill, supra note 85, para. 29.
88 Schill, supra note 85, paras. 30-31.
89 Id. para. 29.
legal system to base itself on.\textsuperscript{90} Even if we assume that it constitutes an independent legal system, it is hard to recognize its applicability to the state contract to which host states’ sovereign act is closely related.

Thus far, scholars and arbitrators who have been argued the application of the \textit{pacta sunt servanda} principle to the state contracts in various ways do not show sound and firm theoretical and legal ground for its application. How states have responded to this approach is next concern of this paper, especially to focus on whether state practice supports the application of the \textit{pacta sunt servanda} principle to the state contracts.

\textbf{B. States’ Stances on the Application of \textit{pacta sunt servanda} to State Contract}

Given the lack of legal ground for any applicable international law or quasi-international law on the state contract, looking into custom and domestic laws of states with regard to the regulation of foreign investment is worthwhile to find out whether there has been established any customary international law or general principles of law applicable to the implementation of the state contract. As international human rights law imposes certain international obligations on states to protect human rights of their nationals and aliens, states may establish international obligations to be bound by the state contract basing on various sources of international law. Then the lack of private individual’s international personality would not act as an obstacle, because states may grant the international personality by recognized sources of international law, i.e. treaty, custom, or general principles of law.\textsuperscript{91} Therefore, states’ stances on the regulation of the state contracts concluded with private entities are crucial in determining the applicability of the principle of \textit{pacta sunt servanda} to the contract.

The states’ positions on the regulation of the state contracts can first be found at the famous debate between developing countries and developed counties over the customary standard on treatment of foreigners. As opposed to the national treatment standard which obliges states only to grant treatment as same as that is granted to their nationals, endorsed by developing countries, the international minimum standard, endorsed by developed countries, requires certain independent treatment to foreigners not contingent to any treatment.\textsuperscript{92}

\textsuperscript{90} Id.

\textsuperscript{91} ICJ’s advisory opinion on the Reparation for Injuries Suffered in the Service of the United Nations case is of highly relevance in this regard.

\textsuperscript{92} Hollin Dickerson, Minimum Standards, Max Planck Encyclopedia of Public International Law, para. 5 (2010).
Obviously, the national treatment standard does not guarantee the protection of foreign investors’ operation of investments inside a host state since the content of national treatment standard depends on a host state’s treatment of its own nationals which is regulated by domestic legal system of the state. On the other hand, the international minimum standard purports to ensure neutral protection of the investments regardless of changes in the host state’s legal system by binding the state to objective international standard. These different approaches culminated in series of UNGA resolutions on the permanent sovereignty over natural resources. The primary concern of those resolutions was how to balance developing states’ sovereignty and foreign investors’ interests. However, inconsistency between Resolutions 1803, 3171, and 3281 were not helpful in establishing customary international law of the international minimum standard. At first it seems to have achieved consensus on the protection of investors by adopting the rule of international law on compensation for expropriation of foreign investments and application of the pacta sunt servanda principle to the state contract almost unanimously, but later developing states changed their stances and dragged a host state’s domestic legal system into the resolution. Thus, finally it is hard to infer the establishment of opinio juris from these resolutions. The inconsistency lies on the subsequent resolutions show that there was not enough consensus sufficient to establish opinio juris. Moreover, even though the adoption of resolution with unanimous vote in favor of it by states may be one factor of opinio juris, it cannot be decisive unless backed by actual state practice.

The state practice can be largely inferred from host state’s responses to arbitration decisions on the state contracts held in favor of foreign investors. But, scholars’ opinions on how host states have responded to the arbitration awards vary. Yackee infers enough state practice to establish custom of applicability the principle of pacta sunt servanda to the state contracts from the host states’ compliances with the arbitration decisions. On the other hand, Sornarajah argues that no such practice has sufficiently cumulated, emphasizing the host states’ frequent nonappearance before the arbitration and their counter arguments against

\[93\] Id.
\[94\] Id. para. 6.
\[95\] For comparison, see Dunoff, supra note 3, 74-77.
\[98\] Id. 81-84.
\[99\] Yackee, supra note 61, 1570.
enforceability of the contract based on their sovereignty.\textsuperscript{100} Despite constant resistance, if not uncontroversial, from the developing states however, content and application of the international minimum standard has been incrementally developed through arbitration awards and relevant treaties.\textsuperscript{101} The ICJ’s judgment on Elettronica Sicula SpA (ELSI) case in which the court interpreted the “constant protection and security” requirement imposed on the U.S. \textit{vis-à-vis} foreign investors relying on the international minimum standard supplemented with the national treatment and most-favoured-nation treatment, contributed to the arbitration tribunals’ propensity.\textsuperscript{102} But, given that the developing states and developed states have not been able to compromise the discrepancy yet, caution should be given to over-reliance on decisions made by ad hoc arbitral tribunals which sometimes said to be “businessmen’s courts.”\textsuperscript{103} The tribunals’ individualized nature does not guarantee coherent application of rule of law, which undermines the legitimacy of their decisions. Some question impartiality of the tribunals pointing out their peculiar dependency on parties to the arbitrations.\textsuperscript{104} Therefore, “mere incantation” of relevant rules and application of the rules by private arbitrators should not be treated as source of binding international law \textit{per se},\textsuperscript{105} which has been done by the \textit{ad hoc} arbitration tribunals oftentimes unfortunately.\textsuperscript{106}

Application of the \textit{pacta sunt servanda} principle as a part of the general principle of laws by arbitrators has not been supported by sufficient evidences of states’ domestic legal systems either. Although developing states have been incorporating more sophisticated legislations regulating foreign investments, this seems to be only a recent trend before which various types of legal systems based on different economic ideologies existed.\textsuperscript{107} Given a lack of clear criteria by which to verify establishment of the general principle of laws, which may be one of the reasons why the ICJ has been reluctant to apply the source, obvious uniformity in adopting a certain legal principle among the domestic legal systems should be

\textsuperscript{100} See also Sornarajah, supra note 29, 249.
\textsuperscript{101} Dickerson, supra note 92, para. 6. It shall be pointed out that surge of bilateral or regional investment treaties do not necessarily establish customary international law, because effect of a treaty is basically restricted to the parties and its beneficiaries. Especially failure of several attempts of international organizations to adopt multilateral investment treaty supports against the effect of the investment treaties for the establishment of the customary international law.
\textsuperscript{103} Alvarez, supra note 1, 86.
\textsuperscript{104} Harten, supra note 6, 6.
\textsuperscript{105} Sornarajah, supra note 29, 266.
\textsuperscript{106} Id.
\textsuperscript{107} Sornarajah, supra note 29, 262-267.
required for the principle to constitute a general principle. All things considered, neither customary international law nor general principle of *pacta sunt servanda* that is applicable to the state contracts can be said to have been established being evidenced by uniform state practice and *opinio juris* of states, or by states’ domestic legal systems.

C. Can *pacta sunt servanda* be a Bridge between State Contract and International Law?

As has been analyzed, applicability of the *pacta sunt servanda* principle to the state contracts does not have any firm and sound legal grounds yet. This means that foreign investors’ independent claim of a breach of the contracts by a host state would not be ensured the enforcement in international stage, despite relevant provisions in the contracts. In other words, arbitration decisions on the breach of the state contracts by the host state do not legally bind the state.\(^{108}\) Two things may be noteworthy however: first, this does not necessarily lead to the absence of any international obligations of the host state owed to the foreign investors. Second, if there was a treaty which contains provisions on a mechanism of investor protection and to which both the host state and home states of the investors are parties, the application of the principle of *pacta sunt servanda* by the arbitral tribunals in the international stage may become binding over the host state.

First of all, a host state’s international obligation exists to some extent, despite having private entities only as beneficiaries of the obligations, not granting independent capacity of bringing an enforceable claim to the investors. As stated by the ICJ in the judgment on the ELSI case international minimum standards have been recognized as the host state’s international obligations *vis-à-vis* the foreign investors,\(^{109}\) notwithstanding the debate over the contents of the standards.\(^{110}\) Unfortunately however, independent remedies for the foreign investors to recourse have not been developed alongside the obligations of the host state. Thus far, the foreign investors need to resort to their home state’s discretionary diplomatic protection.\(^{111}\) Without help of the home state, there is no settled legal system based on which to invoke a breach of the state contract by the host state under the principle of *pacta sunt servanda* from whether public international law or private international law.

Accordingly, international investment treaties concluded by states including a host

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\(^{108}\) Id. 266.

\(^{109}\) See ELSI case, supra note 102, para. 111.

\(^{110}\) See Dickerson, supra note 92, paras. 14-16.

\(^{111}\) Accordingly, the ICJ’s primary concern as to the legal means for the protection of the foreigners’ assets was diplomatic protection by their home states as we can see in its judgments on Barcelona Traction case and ELSI case.
IV. Implication of Investment Treaty for State Contract and its Limitations

Investment treaties have thus been adopted more and more, which reveals the lack of legal system by which to protect investors facing a breach of the state contracts by a host state. The dispute settlement system set up by the investment treaties between states has sounder foundations either from theoretical or legal grounds, providing for the independent dispute resolution system, i.e. the investor-state dispute settlement system, to foreign investors. However, the relevance of the investment treaty dispute settlement system to the state contracts is limited either in that still the state contract-based disputes are brought before ad hoc arbitral tribunals outside of the treaty system, or in that the current investment treaty system itself has not insignificant defects largely based on its bilateralism. For more effective operation of the international investment regime, other supplementary system with which to ensure both a host state and investors’ adherence to the sound dispute resolution system.

A. Implication of Investment Treaty for State Contract

Unlike the state contracts, the investment treaties ground themselves on consents between states to be bound by certain international obligations on the protection of foreign investors. The “fair and equitable treatment (FET),” “full protection and security,” “protection against arbitrary or discriminatory measures,” “national treatment,” “most-favoured-nation treatment,” “rules on the transfer of funds,” “umbrella clauses,” and rules on “expropriation” are all the relevant principles often articulated in the treaties and developed by arbitral tribunals established under the treaties.\textsuperscript{112} Especially the FET and umbrella clause are highly of relevance to the application of the \textit{pacta sunt servanda} principle. The FET, the most attracted and prominent principle for the protection of the investors, has been

\textsuperscript{112} See generally Christoph Schreuer, Investments, International Protection, Max Planck Encyclopedia of Public International Law, paras. 48-89 (2011).
detailed its contents including a host state’s compliance with obligations under the state contracts and the protection of the investors’ legitimate expectations. Thus, the host state bears an international responsibility for a breach of the state contracts under customary international law codified in ARSIWA. This responsibility may be imposed on the host state by resorting to the umbrella clause as well. Even though the scope of contents of the umbrella clause is divided among arbitral tribunals, obligations arising from the state contracts may well fall into the clause under certain circumstances.

These substantive principles are backed by arbitral tribunals to which the relevant treaties confer the power to decide the content. Unlike the traditional dispute settlement system of diplomatic protection, the investment treaties often set up a system granting a strong legal capacity to investors to bring a claim against a host state without resorting to their home states’ intervention, such as arbitral tribunals under the International Center for Settlement of Investment Disputes (ICSID). According to Art. 42(1) of the ICSID Convention, the arbitral tribunals are mandated to “decide a dispute in accordance with such rules of law as may be agreed by the parties.” The exhaustion of local remedies as contained in the rule of diplomatic protection is not required here, and even the diplomatic protection by a home state is prohibited in principle. Finally, decisions made by the arbitral tribunals shall be treated as if those were the final judgment of courts in the host states. The International Chamber of Commerce (ICC) supported by its enforcement system under the New York Convention is among other popular recourse, as well as the UNCITRAL arbitration rules. Based on these sound legal foundations, the number of investment treaties has been drastically grown with that of the arbitration proceedings thereunder.

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113 Id. para. 51.
114 Umbrella clause articulates a general obligation of a host state to observe any obligations concluded with investors, and is said to be operating as a blanket clause in the protection of the foreign investors. See ECT treaty Art. 10(1), cited in Schreuer, supra note 112, para. 80.
115 Marboe, supra note 14, paras. 38-40; Schreuer, supra note 112, paras. 80-83.
116 Sornarajah, supra note 38, 299-300; Voss, supra note 10, 62-64.
117 “The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties. In the absence of such agreement, the Tribunal shall apply the law of the Contracting State party to the dispute (including its rules on the conflict of laws) and such rules of international law as may be applicable.”
118 ICSID Convention, Arts. 26-27.
119 Id. Art. 54(1).
120 See generally Voss supra note 10, 64-65.
121 The number of the bilateral investment treaties amount to more than 2,700. But with regard to the
B. Limitations of the Implication

However, the current international investment regime based on the bilateral investment treaties (BIT) has similar problems to those of the traditional regime based on the state contracts and *ad hoc* arbitral tribunals. Even though the investment treaties have offered sounder legal foundations for arbitral awards for the protection of the investors through, e.g. the implementation of the state contracts, still individualized arbitrators are generating inconsistent decisions and thus, undermining legitimacy and effectiveness of the regime. The arbitrators’ peculiar dependency on parties to the arbitrations and allegedly biased decisions in favor of the investors for the encouragement of foreign investments are fueling the criticism. Moreover, states’ reluctance to resort to the ICSID system has been more and more growing. While financial crises hit Latin American and Asian states, developing states became aware of impact of restrictions on their regulatory powers imposed by the BITs. Developing states were beginning to resist implementing arbitration awards seemingly unbalanced between their interests and protection of investor’s stakes. This crack would lead to more and more ineffective operation of the international investment regime as we can glimpse in Argentina, Venezuela, and Ecuador situation which are only the tip of an iceberg. Although still majority of states abide by arbitration awards by enforcing it, not a small number of states just ignore the enforcement of arbitration awards, e.g. Russia, Thailand, Kyrgyzstan, etc. India and Australia’s recent showing of their hostilities to investor-state arbitration system is also remarkable. Conflicts surrounding limited critical natural resources and protectionism, environment issues, and austerity measures which should be taken by certain European countries would more likely increase possibility of friction between developed states and developing states. The recent dispute between Argentina and Rapsol backed by Spanish government exemplifies this potential problem, which also shows that even investor-state dispute settlement system may not be a perfect solution to depoliticize investment disputes.

In this circumstance, a lack of comprehensive discourse over international investment law regime is problematic. Without the *telos* genuinely agreed to by relevant participants, development and effective implementation of international investment law regime would not be assured. In particular, more and more recent empirical researches reveal limits of the implication of the investment treaties, different approaches exist. See Yackee, supra note 61, 1557-1569. Notwithstanding this refutation, Guzman’s theory on the implication of the treaties for the implementation of the state contracts seems to be more persuasive according to the analysis mentioned above in this paper. See id. 1567.
international investment regime based on bilateral agreements. Above all, even though boost of foreign direct investment (FDI) has made the world richer than before as a whole, not every stakeholder has enjoyed the outcomes. The increase of FDI inflows didn’t necessarily enhance development of host states. Even if it had been contributing to the development somewhat, the fruits were not sufficiently shared by actors in the host states such as workers of supply chains. Formal language of preambles of various BITs aims to the mutual economic development of both parties, but actual provisions only have to do with the protection of foreign investors. Absence of provisions on investors’ responsibility appears to be undermining legitimacy of the regime as well. These have led states to more distrusting investor-states arbitration awards based on BITs which put huge thumb on investor’s scale, which is not good for the investors either. Unlike old days, developed states have become more caring about these as well as developing states do since the number of multinational corporations from developing states have been rapidly growing. Modification of BITs to make the scale even for both the host states and the investors does not seem to be feasible or helpful under the current fragmented system, however. Host states would not want to undermine their attractiveness by inserting investor’s responsibility in the BITs. In the meantime, home states would face substantial opposition from multinational corporations. Given the existence of BITs itself may not be a crucial determinant for investors in deciding FDIs—Market size of host states or political risks of those states would be more important factors to consider for them—the provisions on investor’s responsibility may lead the investors to withdraw from the host states.

C. The Need for a New Supplementary System

Multilateral system would be a better place on which the object and purpose of the international investment law regime and the ways to enhance its effectiveness by reflecting all the relevant stakeholders’ interests are being discussed than fragmented bilateral treaties and agreements. Under the multilateral system, the object and purpose of international investment law regime appearing on BITs and ways to enhance its effectiveness by reflecting all the relevant stakeholders’ interests should be revisited and thoroughly discussed to the extent that genuine consensus would be reached. Political and economic analysis of the free market theory and the protectionism should be scrutinized again especially being faced with the global financial crisis and various responses by states to it. Regional system may make

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122 As to the effect of FDIs on the development of the host states, debate has been going on among scholars based on empirical studies. See Yackee, supra note 61, fn. 3, 1551.
123 Alvarez, supra note 1, 95.
up to some extent defects of the bilateral system, but it governs only inside of certain regions. As opposed to bilateral and regional system, multilateral system has four main features crucial for achieving the aim. First of all, in multilateral system, states could participate in the discourse with more equal footing. Respecting sovereign equality of each state and putting on the table all the possible considerations including various interests of all the relevant stakeholders, more transparent and democratic decision-making would be possible. Second of all, reforming current individualized arbitration system to more consistent and predictable system would be possible, through which legitimacy of the regime would be enhanced. Third of all, this would contribute to responsible operation of investment by investors and regulation of economic environment by host states with objective monitoring body whether it consists of independent experts or of relevant stakeholders. Finally, through all of these merits more effective operation of the regime would be possible. From the negotiation of investment to the settlement of disputes, multilateral forum in which every stakeholder’s interests are sufficiently considered and reflected would make everybody better off.

Nevertheless, already failed attempts to establish multilateral treaty on the international investment would easily discourage repeated try for the future. The past attempts by various international organizations have all been unsuccessful failing to reconciling interests of all the relevant actors, developing states, and developed, and foreign investors. The lesson that can be learned from these failures is that as much focus should be put on incentives by which to induce the actors to engage in the system as that on disciplines by which to impose obligations on them. Thus, insurance of positive outcomes out of the investments should be linked to the disciplinary measures. The multilateral political insurance system under the Multilateral Investment Guarantee Agency (MIGA) is of crucial relevance in that sense, for enhancing the responsible conduct by both actors with regard to the FDIs. MIGA’s insurance system has led many investors to investing in developing states while it was assuring the investors’ responsible operation of their investment, i.e. for developing states’ economically and socially sustainable development. Its combined use of incentives and disciplines for the sake of both host states and investors is remarkable especially given MIGA’s successful achievement in attracting FDIs that has actually contributed to the development of developing states. Despite MIGA’s accomplishment however, its scope of management is restricted only to limited number of states.

124 With regard to the brief history of the attempts to establish multilateral investment treaty, see generally Dunoff, supra note 3, 74-77.
poor states and certain eligible investors. By engaging it in the broader discourse connected to multilateral investment treaty, especially through expanding its role to include wider range of investors and host states, MIGA’s carrot-and-stick strategy would make it possible the effective operation of the whole multilateral system. Funds established by insurance fee submitted by relevant actors may offer peculiar resources for eradicating arbitrators’ dependency on parties. Providing for the insurance system contingent on responsible operation of investment by investors and more predictable treatment of investments by a host state would contribute to more effective and sound operation of the investment regime. Assistance in contract negotiation and drafting for the state contract and treaties would prevent inadvertently unrealistic commitments by a host state, which would more likely than not lead to a breach of its obligations. This will lead to fairer application of the principle of *pacta sunt servanda* and more enhanced compliance therewith, so as to strengthen the legal foundations of the international investment regime.

V. Conclusion

To sum up, international investment law regime should offer a comprehensive multilateral agenda setting forum and ensure legitimate and responsible operation of the system for establishment of values, and their effective implementation, as opposed to each actor pursuing mere short-term self-interest. This is especially needed in ever more globalizing world in which the rich has been richer but not the poor. However, current international investment regime is based on individualized arbitral decisions and literatures, and is swayed thereby. Especially the state contract concluded between developing states and foreign investors has been implemented not based on sound legal grounds but on pragmatic reasons for the protection of the investors. The prevalence of investment treaties has been supporting the missing legal foundations to the weakly founded regime, but still quite individualized arbitral tribunals are undermining the legitimacy of the whole regime by generating inconsistent decisions. What failed attempts to establish multilateral forum in which to comprehensively and more effectively regulate the international investment regime suggest is however, not short time would take to get to the multilateral investment treaty because of still significant discrepancy between interests of developing states and investors backed by their developed states. Thus, harmonizing all the relevant stakeholders’ interests should be focused on above all, so as to induce them to participate in more balanced and stable regime where every actor can enjoy the fruit of the investments. The multilateral
political insurance system being managed by MIGA is crucial in this sense, whose mandate should be broadened to include not only very poor host state and relatively major private entities. The insurance system would operate as a crutch for the current investment regime which has not been developed as the comprehensive system yet.