THE CHALLENGES AND THE FUTURE OF COMMERCIAL AND INVESTMENT ARBITRATION

Liber Amicorum Professor Jerzy Rajski

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How Wide is the Door to Turn Contracts into Treaty Obligations? Reflections on Prof. Rajski's Dissenting Opinion in *Eureko*

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1. Introduction

From the perspective of an international investment law scholar, a tribute to Prof. Rajski by necessity hinges upon his elaborative dissenting opinion in the *Eureko v. Poland* case.[1] The present contribution concerns the most famous passage of the said opinion, in which Prof. Rajski stated that:

> by opening a wide door to foreign parties to commercial contracts concluded with a State-owned company to switch their contractual disputes from normal jurisdiction of international commercial arbitration tribunals or state courts to BIT Tribunals, the majority of this Tribunal has created a potentially dangerous precedent capable of producing negative effects on the further development of foreign capital participation in privatizations of State-owned companies.[2]

Whilst on the basis of current developments in international law one may disagree with that statement, there can be no doubt that Prof. Rajski touched upon the very basic issue of the nature of a State's participation in relations with private entities and, more generally, the problems connected with adaptation of traditionally understood functions of a sovereign State to the realities of a global economy, the complexity of the socio-economic structure of the international community and increasing participation of non-State entities in exercising State functions.

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[1] *Eureko B.V. v. The Republic of Poland*, partial award of 19 August 2005. Dissenting Opinion of Professor Jerzy Rajski; available at www.italaw.com ('Dissenting Opinion').

[2] Dissenting Opinion, at para. 11.

The present paper seeks to establish whether there are legal grounds to create a general international legal obligation to observe contracts entered into by States with private foreign investors. To put it differently, the author intends to respond to Prof. Rajski's concern as to the possible creation of a 'privileged class of foreign parties to commercial contracts who may easily transform their contractual disputes with State-owned companies into BIT disputes'.[3] That concern will be confronted with one of the general principles of law, i.e. the principle of *pacta sunt servanda* evaluated as against private entities.[4] Following the assumed positive answer to the question above, the author attempts to set limits to a State's responsibility for violating such international legal obligation without, however, discussing the question of availability of a proper forum to resolve disputes, such as BIT Tribunals. Finally, taking into account Prof. Rajski's particular emphasis on practical consequences of granting relief for violating contractual obligations, the author focuses on how accepting States' responsibility for violating contracts with private entities affects the position of States in a globalized economy.

2. The source of international legal status of contracts with foreign investors

Without doubt, when a State concludes a treaty with another State it becomes bound by it on the basis of the *pacta sunt servanda* rule.[5] Whilst it is difficult to find the exact source of the *pacta sunt servanda* rule in international law, without that rule international law would constitute nothing more than a mere apology of States' interests.[6] At the same time, acknowledging the leading nature of the rule does not in itself presuppose the internationally binding nature of State contracts. On the other hand, if

[3] *Ibidem.*

[4] On that topic see, for instance, I. Alvik, *Contracting with Sovereignty. State Contracts and International Arbitration*, Oxford: Hart Publishing 2011; M. Świątkowski, *Naruszenie przez państwo umowy z inwestorem zagranicznym w świetle traktatów inwestycyjnych*, Warszawa: CH Beck 2009.

[5] As per Article 26 of the Vienna Convention on the Law of Treaties: 'Every treaty in force is binding upon the parties to it and must be performed by them in good faith'. United Nations Treaty Series (UNTS) No. 18232.

[6] M. Koskenniemi, *From Apology to Utopia. The Structure of International Legal Argument*, Cambridge University Press 2006, p. 309 *et seq.*; C. Mik, *Zasada wykonywania zobowiązań w dobrej wierze w orzeczeniach arbitrażu międzynarodowego*, in: C. Mik (ed.), *Arbitraż w prawie międzynarodowym*, CH Beck 2014, p. 101.

one accepts that at the basis of *pacta sunt servanda* lies the assumption that States are bound by what they agreed to,[7] to establish whether a State is bound by a contract it would be necessary and sufficient to find its intent to create an international legal obligation out of such contract. As pointed out by O. Corten and P. Klein with respect to agreements with liberation movements to establish their status as sources of international legal obligations, the authors:

> attempted to establish whether, beyond the specificities of each agreement, these reflected *the parties' will* to endow them with any kind of 'legal force' under international law, and more generally to ground them in the international legal sphere [emphasis added].[8]

With respect to State contracts, to find parties' intention to subject them to international legal order is not an easy task. In all instances, putting such contract within the frames of international law requires a methodological approach called 'internationalization' of the contract. And yet, such internationalization need not necessarily lead to the conclusion that such contract will be governed by international law.[9]

Conceptually it is possible to base such internationalization on three grounds. Firstly, the contract may be internationalized explicitly by the parties through the provision on applicable law included in the contract. Secondly, it is conceivable that the parties intend to subject the contract to international law by having recourse to international arbitration with the tribunal's seat outside the territory of a State – party to the contract. Thirdly, which was a situation discussed by Prof. Rajski, the private entity – a party to the contract, can make use of the umbrella clause in a bilateral investment treaty ('BIT') disregarding the choice of law made by the parties to the contract. In all three instances, any law-applying body, be it the commercial arbitration tribunal, BIT tribunal or any other court, must establish that the State-party had the will to contract and oblige itself by an international legal obligation to observe the contract.

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[7] H. Kelsen, *The Pure Theory of Law*, Berkeley University of California Press 2005, p. 216 (note 80). Notwithstanding the flaws of Kelsen's theory of *'Grundnorm'*, there is no feasible theory of sources which could disregard the States' will to be bound as the main source of international legal obligations.

[8] O. Corten, P. Klein, *Are Agreements between States and Non-State Entities Rooted in the International Legal Order*, in: E. Cannizaro (ed.), *The Law of Treaties Beyond the Vienna Convention*, Oxford University Press 2011, pp. 4–5.

[9] E. Gaillard, *Legal Theory of International Arbitration*, Leiden-Boston: Martinus Nijhoff 2010, p. 35 *et seq.*

3. Internationalization through the applicable law clause

Out of the three abovementioned instances of internationalization, choosing explicitly international law as the law governing the contract is considered to be the easiest to conceive and accept. In such situation, a state's intent to be internationally bound by the contract is more or less clear and unequivocal. As in almost all contracts, the parties' will is to be observed by any judicial authority irrespective of whether that fact is based upon international law[10] or any other system of law stipulating the parties' freedom to select the law governing their contracts.[11] On the other hand, the parties rarely select international law explicitly, referring rather to more vague terms as 'general principles of law', 'usages', or making no reference to the applicable law whatsoever. Thus, the question remains whether these types of references or lack of reference respectively allow for international law to be applied, especially if a State-party to the contract refuses to acknowledge such applicability once a dispute arises.

There are two possible ways to respond to that question. The first option was expressed by the Permanent Court of International Justice in the *Serbian Loans* case, according to which: '[a]ny contract which is not a contract between States in their capacity as subjects of international law is based on the municipal law of some country'.[12] Such an approach would require a judge or an arbitrator to make use of the rules of the conflict of laws applicable at the seat of a court or tribunal in order to find the proper national law to govern the contract. Whilst conceivable, this option has an important disadvantage if perceived from the point of view of the contract equilibrium, as most likely such contract would be governed by the law of the State-party to the contract. The second option requires choosing the most appropriate law to be applied by an arbitration tribunal and is expressed in a number of arbitration rules.[13] Consequently, it

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[10] In other words, it is not necessary to determine whether it is international law that decides that parties to such contract may choose international law as the law governing the contract.

[11] See, for instance, Regulation (EC) No. 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I), O.J. 4.7.2008, Series L-177, p. 6, Article 3.

[12] Case concerning the payment of various Serbian Loans issued in France, PCIJ Judgment of 12 July 1929, *Publications de la Cour Permanente de Justice Interationale*, Series A (20) 1929, p. 41.

[13] For example, according to Article 21 of the ICC Arbitration Rules: 'The parties shall be free to agree upon the rules of law to be applied by the arbitral tribu-

would be up to the arbitrators to establish, on the one hand, whether it is possible to assume the State's consent to have the contract governed by international law and, alternatively, whether international law is the proper system of law to govern the specific contractual relationship.

4. Internationalization through umbrella clauses

The situation encountered by the arbitrators in the *Eureko* case was different to that mentioned above and, yet, quite common to investment treaty arbitration. In the contract, the parties chose Polish law as exclusively applicable to contractual disputes which were supposed to be resolved solely by Polish courts. The only ground on which the contract was lifted to the level of international law was the so-called umbrella clause contained in Article 3(5) of the Polish-Dutch BIT, which stipulates that: 'Each Party shall observe any obligation it may have entered into with regard to investments of investors of the other Contracting Party.' The umbrella clause was conceived specifically with a view to cases such as *Eureko*, i.e. in order to provide international law protection to investors who conclude contracts with host States and subject them to local law which may be changed unilaterally by one party to the contract.[14] Irrespective of the practical, actual or potential, consequences of such clause, there can be no doubt that its effect is that the parties to an international treaty accept a binding international obligation to observe contracts with foreign investors. As the necessary effect of an obligation is responsibility, i.e. the ability to endure negative consequences in a situation of violation of that obligation,[15] the primary question remains, namely how should the words 'shall observe any obligation it may have entered into' be interpreted?[16] However, there

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nal to the merits of the dispute. In the absence of any such agreement, the arbitral tribunal shall apply the rules of law which it determines to be appropriate.'

[14] A.C. Sinclair, *The Origins of the Umbrella Clause in the International Law of Investment Protection*, Arbitration International 4, 2004, p. 411.

[15] As stipulated in Article 12 of the ILC Articles on State Responsibility: 'There is a breach of an international obligation by a State when an act of that State is not in conformity with what is required of it by that obligation, regardless of its origin or character.'; International Law Commission Articles on State Responsibility for Internationally Wrongful Acts, *Yearbook of the International Law Commission* 2, (2011) Part Two ('ILC Articles on Responsibility'); See also P. Weil, *Problems relatives aux contracts passes entre un état et un particulier*, Collected Courses of the Hague Academy of International Law (128) 1969, p. 132.

[16] The majority in *Eureko* stated, among others that '[t]he plain meaning – the "ordinary meaning" – of a provision prescribing that a State "shall observe

can be no doubt that should the umbrella clause be found to be applicable, a host State bears responsibility for its violation before the proper investment arbitration tribunal, established on the basis of the particular BIT. On the other hand, the mere acknowledgment of the existence of potential international responsibility for violation of a contract does not amount to admitting that through the umbrella clause *all* contracts or contractual obligations are elevated to the level of treaty obligations.

The most recent case-law seems to follow the view expressed by the tribunal in the *SGS v. Philippines* case that an umbrella clause 'does not convert questions of contract law into questions of treaty law. In particular it does not change the proper law of the [...] Agreement from the law of the Philippines to international law.'[17] Consequently, the existence and terms of obligations created on the basis of a contract are subject to local law. Undoubtedly, no such review was made by the majority in the *Eureko* case, which led to Prof. Rajski making his famous statement. On the other hand, once established, a specific obligation under the contract (as interpreted on the basis of applicable law) potentially becomes an obligation protected by a treaty. Only with such assumption, would it be possible for the umbrella clause to make any sense. As stated by the arbitrators in the *Ioan Micula v. Romania* case, '[t]he purpose of the umbrella clause is to cover or 'elevate' to the protection of the BIT an obligation of the state *that is separate from, and additional to*, the treaty obligations that it has assumed under the BIT' [emphasis added].[18] Therefore, the application of the umbrella clause allows a tribunal to determine international responsibility of a host State for a violation of the obligation which is shaped, both as to subjects and its object, by the law applicable to a particular contract. Only within such understanding does the State's responsibility for a violation of the umbrella clause not become contractual responsibility which may be simultaneous or, what would be even more dangerous, contrary to responsibility under local law. To the contrary, responsibility under international law requires two elements, i.e. attribution of a certain act to a State and

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any obligations it may have entered into" with regard to certain foreign investments is not obscure. The phrase, "shall observe" is imperative and categorical. "Any" obligations is capacious; it means not only obligations of a certain type, but "any" – that is to say, all – obligations entered into with regard to investments of investors of the other Contracting Party'; see *Eureko v. Poland*, at para. 246.

[17] *SGS Société Générale de Surveillance S.A. v. The Republic of Philippines*, Decision on Jurisdiction of 29 January 2004, ICSID Case No. ARB/02/6, at para. 126; recently that statement was endorsed by the Tribunal in the *Ioan Micula, Viorel Micula, S.C. European Food S.A., S.C. Starmill S.r.l. and S.C. Multipack S.R.L. v. Romania*, Award of 11 December 2013, ICSID Case No. ARB/05/20, at para. 417.

[18] *Ioan Micula v. Romania*, at para. 417.

a breach by that State of its international obligation whatever may have been its source (including contracts and bilateral investment treaties).[19] This requires that the contract must be entered into by a State, either by a State organ (named as such or a *de facto* organ) or by a private entity acting under the State's control or instructions.[20] Whilst with respect to State organs as stipulated in the national law of a particular State there is no need to look into the nature of a contract, i.e. whether or not it concerns *imperium*, with respect to remaining groups of entities for attributing their conduct to the State, establishing whether in a particular instance they were acting within frames of sovereign activities, would be necessary.[21] Interestingly, investment arbitration tribunals rarely review this issue when discussing the issue of attribution of a contract, and consequently its violation, by the State.

How, therefore, is it possible to confront the exclusive applicable law clause in the contract with the international law obligation to observe obligations which arise out of such contract? That question was referred to as 'perpetual tension' between:

> on the one hand, the proposition that a host State cannot rely on its own law as a justification for failing to comply with its international obligations, including those obligations arising under treaties for the protection of foreign investment; on the other, the proposition that an investment is, in the very first place and by definition, a transaction occurring in the host State and governed by its laws.[22]

This question was subject to review, e.g. by the ICSID *ad hoc* Committee in the *Vivendi v. Argentina* case, later also referred to by the majority in *Eureko*. The Committee seems to suggest that, conceptually speaking, State responsibility for a breach of international law is distinct from the responsibility for breaching a contract. As the Committee put it: '[a] state may

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[19] See Article 2 of the ILC Articles on Responsibility.

[20] See Articles from 4 to 8 of the ILC Articles on Responsibility. In the Dissenting Opinion, Prof. Rajski also stated that the contract with Eureko was not entered into by Poland given the Minister of Treasury was acting in his capacity as the representative of the owner of the PZU Company, i.e. the State Treasury which is a separate legal entity from the State under Polish law.

[21] See, for instance, *CMS Gas Transmission Company v. the Argentine Republic*, Award of 12 May 2005, ICSID Case No. ARB/01/8, at. para. 299 ('*CMS v. Argentina*'); J. Crawford, *Treaty and Contract in Investment Arbitration*, Transnational Dispute Management (6) 2009, pp. 1–2.

[22] *Ibidem*.

breach a treaty without breaching a contract, and *vice versa*'.[23] However, with respect to the umbrella clause, the relationship between both types of obligations is different. There can be no breach of international law without a breach of a contract and, consequently, the breach of a contract, thanks to the umbrella clause, is elevated to a breach of international law. Consequently, whilst evaluation as to whether a contractual obligation was fulfilled is subject to the law applicable to the contract, it is ultimately subject to an international law application (and interpretation) of the umbrella clause, as stated by the *ad hoc* Committee in the *CMS v. Argentina* case: 'the effect of the umbrella clause is not to transform the obligation which is relied on into something else; the content of the obligation is unaffected, as is its proper law'.[24] This led the Committee to firstly check whether under Argentine law CMS could have invoked the contractual rights against Argentina and only then would it have found a possible violation of international legal obligation under the umbrella clause.

To conclude, a reasonable approach requires that *pacta sunt servanda* should apply on both levels, i.e. contractual and treaty. However, the existence of *pactum* depends on the national law (in the first instance). The author believes that such an approach addresses Prof. Rajski's concern while at the same time acknowledging that a State is internationally bound by obligations it has freely entered into.

5. Internationalization through other standards of investment protection

Apart from an explicit duty to observe obligations entered into by a State towards foreign investors, contained in umbrella clauses, contracts may also be protected by other standards of investment and investor protection, in particular by the fair and equitable treatment standard ('FET') and by the non-expropriation standard.

With respect to FET, it seems natural to connect contractual obligations of a host State with the institution of legitimate expectations of an investor. Thus, if there is a contractual, legal obligation concerning certain conduct of a State, this does create a legitimate expectation of an investor that such obligation will be fulfilled. However, as with the umbrella clause, to establish a violation of the contractual obligation it is necessary to determine

[23] *Compañia de Aguas del Aconquija S.A. and Vivendi Universal v. Argentine Republic*, Decision on Annulment of 3 July 2002, ICSID Case No. ARB/97/3, at para. 95.

[24] *CMS v. Argentina*, Decision of the *ad hoc* Committee on the Application for Annulment of the Argentine Republic of 25 September 2007, at para. 95(c).

the proper law of a contract which, usually, is the local law. This allows a tribunal to elaborate on the contractual relationship and decide whether the investor has legitimate expectations based thereon or whether a State has a right to affect the investor's rights due to the terms and conditions stipulated in the contract.[25] For instance, such elaboration was key to findings by the majority in the *Occidental v. Ecuador* ICSID case, in which the largest award on record was issued.[26] The Tribunal, independently from any elaboration by local courts, stated that Occidental did violate the contract and it could not have legitimately expected that Ecuador will not resort to the so-called *caducidad* measure which effectively meant a termination of the contract. On the other hand, the Tribunal found a violation of the legitimate expectations based upon the contract, by introducing a new law which effectively took 50 per cent of revenue from the investor in the case of dispossession of the participation in the contract to another entity without authorization from the proper State organ.

The *Occidental v. Ecuado*r case is also interesting from the point of view of the relationship between a contract and the non-expropriation provisions of BITs. It seems natural to assume that when a State decides to terminate a contract, it ultimately expropriates an investor of its investment which was made through or by the contract. However, not all termination leads to States' responsibility under BITs and the question remains as to how to decide whether in a particular case the State must pay compensation or not. From recent case-law it seems that a tribunal's decision depends on the status of such a termination under the particular contract or under the law applicable to it. In the recent *Vigotop v. Hungary* case, the tribunal adopted a very strict approach by focusing on the fact that 'the Concession Contract was not terminated by way of legislative act or executive decree, but rather by Respondent's exercise of negotiated contractual termination rights, on the grounds that Claimant allegedly failed to comply with its contractual obligations'.[27] This led the tribunal to state that 'there is

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[25] Another issue to be discussed in that context is whether an arbitral tribunal is bound by a local court's judgment with respect to the breach of contract. This, however, is beyond the scope of the present contribution. Recently the author published another paper devoted solely to that topic. See M. Jeżewski, *Swoboda orzekania sądów międzynarodowych co do prawa krajowego ze szczególnym uwzględnieniem arbitrażu inwestycyjnego*, in: A. Wyrozumska (ed.), *Swoboda orzekania sądów międzynarodowych*, Łódź: WPiA 2014, p. 112 *et seq.*

[26] Approx. USD 1.8 billion; *Occidental Petroleum Corporation, Occidental Exploration and Production Company v. the Republic of Ecuador*, Award of 5 October 2012, ICSID Case No. ARB/06/11 ('*Occidental v. Ecuador*'), at para. 876(v).

[27] *Vigotop Limited v. Hungary*, Award of 1 October 2014, ICSID Case No. ARB/11/22, at para. 312.

common ground insofar as all of the tribunals considered sovereign or governmental conduct on the part of the State to be a necessary requirement for a finding of an expropriation'.[28] At the same time the tribunal reviewed previous case-law to find out if the question of termination being in accordance with the contract is either necessary or sufficient to establish expropriation. Thus, the arbitrators acknowledged that previous tribunals: 'included alleged non-contractual motives for terminating the contract in their discussion on whether it was '*legitimate*' or '*reasonable*' to terminate the contract in the respective circumstances'.[29] Characteristically, the tribunal specified the following order of its analysis: first, it had to determine if Hungary (the respondent) acted in its sovereign capacity when it terminated the Concession Contract;[30] second, and only assuming the answer to the first question was positive, it was entitled to evaluate the terms of the contract and the applicable law. In other words, the tribunal excluded the possibility that a State may expropriate an investor by simply terminating a contract even if it acted in breach thereof. The other side of the same coin is the investor's obligation to resort to contractual remedies when the State acts simply as a party to the contract. Then, the only remaining remedy under the BIT is a claim of denial of justice which, by the way, is very difficult to prove and which usually does not deal with the merits, i.e. whether the local court's judgment affirming termination of the contract was right or wrong. The approach adopted by the tribunal in *Vigotop* is very strict indeed. It should be emphasized that even a finding of potential inappropriateness of Hungary's termination would not necessarily lead to the tribunal's finding of a BIT violation as the tribunal did not elaborate on this at all. On the other hand, the tribunal admittedly adopted the proper view with respect to the applicable law for evaluating the contract in the first instance (i.e. the local law) and for evaluating whether a BIT violation occurred (i.e. international law).

A different approach was taken by the tribunal in the abovementioned *Occidental v. Ecuador* case. However, that case could be distinguished because of the fact that the contract was terminated through the so-called *caducidad* which is primarily an administrative measure. On the other hand, the conditions for applying *caducidad* were prescribed in the contract by reference. One of the main contentions made in *Occidental* con-

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[28] *Ibidem*, at para. 317, quoting *Impregilo S.p.A. v. Islamic Republic of Pakistan*, Decision on Jurisdiction of 22 April 2005, ICSID Case No. ARB/03/3, at para. 260.

[29] *Ibidem*, at para. 327.

[30] Such an approach was called '*puissance publique test*'. See J.O. Voss, *The Impact of Investment Treaties on Contracts between Host States and Foreign Investors*, Leiden-Boston: Martinus Nijhoff 2011, p. 174.

cerned the principle of proportionality. The claimant asserted that Ecuador violated the principle of proportionality since there were less severe measures than terminating the contract altogether. Interestingly, while discussing the issue of whether Ecuador violated the principle of proportionality, the Tribunal devoted a significant part of the reasoning to the status of proportionality principle under Ecuadorian law explaining that 'Clause 22.1. of the Participation Contract provides that the contract is to be governed exclusively by Ecuadorian law'.[31] Based on the parties' expert submissions, the tribunal came to the conclusion that indeed the principle of proportionality forms part of the Ecuadorian legal order. However, simultaneously the tribunal relied on 'a growing body of arbitral law, particularly in the context of ICSID arbitrations, which holds that the principle of proportionality is applicable to potential breaches of bilateral investment treaty obligations' and concluded that '[t]he obligation for fair and equitable treatment has on several occasions been interpreted to import an obligation of proportionality'.[32] Ultimately, the Tribunal stated, also based upon the law governing the contract, that termination was not a proportional sanction to the violation of the contract by the investor. In that sense one may argue that the arbitrators put themselves in the middle of the contractual dispute without in fact even referring to the umbrella clause.

6. Conclusions

It seems that Prof. Rajski's concerns regarding the open path for contractual claims to be resolved by investment arbitration tribunals despite proper provisions of applicable law and jurisdiction, were heard and, to much extent, answered. On the one hand, it is quite clear that arbitration tribunals cannot step into the proper forum's feet and are entitled to focus solely on treaty claims. On the other hand, one needs to remember that if a contract provides for the applicability of local law, such local law may and should be treated by arbitrators as a fact which determines whether there was a violation of an international obligation by the State.[33] Consequently

[31] *Occidental v. Ecuador*, at para. 396.

[32] *Ibidem*, at para. 404.

[33] The classical description of that relationship was stated in the PCIJ judgment in the *Case concerning certain German Interests in Polish Upper Silesia (The Merits)*, Judgment of 25 May 1926, *Publications de la Cour Permanente de Justice Interationale*, Series A (7) 1926, p. 19, as follows: 'From the standpoint of International Law and of the Court which is its organ, municipal laws are merely facts which

the tribunals must seek a balance between becoming purely commercial and too public law oriented. The socioeconomic realities do not help much due to the ever varying forms of States' involvement in the economy and relations with individuals. The final determination of a State's responsibility for a violation of contractual arrangements shall be, thus, ultimately dependent on the particularities of each case. From the point of view of State officials who represent States in different contractual relationships, it is necessary to think, before acting, whether he or she could have acted in the same way if he or she was not representing the powers of the State.

express the will and constitute the activities of States, in the same manner as do legal decisions or administrative measures. The Court is certainly not called upon to interpret the Polish law as such; but there is nothing to prevent the Court's giving judgment on the question whether or not, in applying that law, Poland is acting in conformity with its obligations towards Germany under the Geneva Convention.'