

RL-0037-ENG

Principles of International Investment Law

Second Edition

RUDOLF DOLZER
and
CHRISTOPH SCHREUER

OXFORD
UNIVERSITY PRESS

Tribunal as a unit... The Tribunal is satisfied, based on the evidence presented to it, that approval of an investment by the FIC for a project that is against the urban policy of the Government is a breach of the obligation to treat an investor fairly and equitably.¹⁵²

cc. *Compliance with contractual obligations*

Closely related to the issue of protection of the investor's legitimate expectations is the question to what extent this protection extends to observance of obligations arising from contracts. Contractual agreements are the classical instrument in most, if not all, legal systems for the creation of legal stability and predictability. Therefore, *pacta sunt servanda* would seem to be an obvious application of the stability requirement that is so prominent in the FET standard. The connection between this aspect of FET and the umbrella clause¹⁵³ is evident.

In a number of cases dealing with the protection of the investors' legitimate expectations, these expectations were actually based on contractual arrangements with the host state. But it does not follow that every breach of a contractual obligation by a host state or one of its entities automatically amounts to a violation of the FET standard.

Some tribunals seemed to hold the view that failure to observe contractual obligations on the part of a government would be contrary to the FET standard.¹⁵⁴ The Tribunal in *Mondev*¹⁵⁵ found it clear that the protection of Article 1105(1) of the NAFTA extended to contract claims. The Tribunal said:

a governmental prerogative to violate investment contracts would appear to be inconsistent with the principles embodied in Article 1105 and with contemporary standards of national and international law concerning governmental liability for contractual performance.¹⁵⁶

Similarly, in *SGS v Paraguay*,¹⁵⁷ a case involving unpaid invoices for pre-shipment inspections, the Tribunal spoke of a 'baseline expectation of contractual compliance'. It noted that:

a State's non-payment under a contract is, in the view of the Tribunal, capable of giving rise to a breach of a fair and equitable treatment requirement, such as, perhaps, where the non-payment amounts to a repudiation of the contract, frustration of its economic purpose, or substantial deprivation of its value.¹⁵⁸

Most tribunals have adopted a more restrictive approach. They have found that a simple breach of contract by a state would not trigger a violation of the FET

¹⁵² At paras 165, 166. Chile's attempt to have the Award annulled was unsuccessful: *MTD v Chile*, Decision on Annulment, 21 March 2007.

¹⁵³ See Section 3.

¹⁵⁴ Tentatively: *SGS v Philippines*, Decision on Jurisdiction, 29 January 2004, para 162; *Noble Ventures v Romania*, Award, 12 October 2005, para 182; *SGS v Paraguay*, Decision on Jurisdiction, 12 February 2010, paras 144–51.

¹⁵⁵ *Mondev v United States*, Award, 11 October 2002.

¹⁵⁶ At para 134.

¹⁵⁷ *SGS v Paraguay*, Decision on Jurisdiction, 12 February 2010.

¹⁵⁸ At para 146.

standard.¹⁵⁹ Rather, 'a breach of FET requires conduct in the exercise of sovereign powers'.¹⁶⁰ However, a termination of the contract, brought about through the employment of sovereign prerogative, would lead to a violation of the FET standard.¹⁶¹ The same would apply to government interference with a contract between an investor and a state entity.¹⁶²

In *Consortium RFCC v Morocco*¹⁶³ the dispute had arisen from a contract for the construction of a motorway. The Tribunal held that only measures taken by Morocco in its sovereign capacity were capable of breaching the FET standard. A violation of contractual obligations that could have been committed by an ordinary contract partner would not rise to the level of a violation of the FET standard.¹⁶⁴

A simple failure to pay sums due under a contract is not a sovereign act and may not amount to a breach of the treaty-based FET standard.¹⁶⁵ In *Waste Management*,¹⁶⁶ the Tribunal described transparency and reliance as elements of the FET standard contained in Article 1105(1) of the NAFTA. One of the claims concerned the failure of the city of Acapulco to make payments under a concession agreement.¹⁶⁷ The Tribunal did not find that this amounted to a violation of FET:

even the persistent non-payment of debts by a municipality is not to be equated with a violation of Article 1105, provided that it does not amount to an outright and unjustified repudiation of the transaction and provided that some remedy is open to the creditor to address the problem.¹⁶⁸

Impregilo v Pakistan concerned a contract for the construction of hydroelectric power facilities. The Tribunal found that a simple breach of contract did not amount to a breach of the FET standard. Responsibility under the treaty would only be caused by a misuse of public power.¹⁶⁹

In *Duke Energy v Ecuador*¹⁷⁰ the claimant relied on power-purchase agreements between its local subsidiary and a state entity. The Tribunal pointed out that a violation of a contract does not as such amount to a violation of the treaty standard of fair and equitable treatment:

¹⁵⁹ *Parkerings v Lithuania*, Award, 11 September 2007, paras 344–5; *EDF v Romania*, Award, 8 October 2009, paras 238–60; *Burlington v Ecuador*, Award, 2 June 2010, para 204; *Hamester v Ghana*, Award, 18 June 2010, paras 332–8.

¹⁶⁰ *Bayindir v Pakistan*, Award, 27 August 2009, para 377. See also para 180.

¹⁶¹ *Rumeli v Kazakhstan*, Award, 29 July 2008, para 615.

¹⁶² *Alpha v Ukraine*, Award, 8 November 2010, para 422.

¹⁶³ *RFCC v Morocco*, Award, 22 December 2003.

¹⁶⁴ At paras 33–4.

¹⁶⁵ *Biwater Gauff v Tanzania*, Award, 24 July 2008, para 636. See further p 129.

¹⁶⁶ *Waste Management v Mexico*, Final Award, 30 April 2004.

¹⁶⁷ At paras 108–17.

¹⁶⁸ At para 115. This part of the decision is cited with approval in *GAMI v Mexico*, Award, 15 November 2004, para 101.

¹⁶⁹ *Impregilo v Pakistan*, Decision on Jurisdiction, 22 April 2005, paras 266–70; Award, 21 June 2011, paras 293–310.

¹⁷⁰ *Duke Energy v Ecuador*, Award, 18 August 2008.

central government. It is equally clear that the internal constitutional structure of a country cannot alter these obligations.¹⁸

Tribunals have applied this rule to provinces,¹⁹ constituent states,²⁰ and municipalities.²¹

2. State entities

(a) The role of state entities

In a number of countries, policy issues and operational matters concerning foreign investments are not handled by the central government. Instead, state entities have been created for the purpose of dealing with foreign investors (or with all investors). The position within the hierarchy of the government and the degree of legal independence of these entities vary. The reasons for the establishment of these separate entities are primarily specialization and efficiency.²²

The existence of these separate national entities in the field of foreign investment must be reconciled with the international principle of the unity of the state. This has raised issues of attribution of acts of these entities to the state, which are not restricted to the field of foreign investment. Domestic classifications will not be decisive in this context. These issues form part of general international law, and they play a significant role in matters of state responsibility. In the field of foreign investment, matters of attribution have most often come up on the side of the respondent when a state argues that acts by state entities cannot be attributed to the state. However, the issue may also be relevant for a claimant whom a respondent considers as a state entity rather than a national of another state.²³

In principle, state entities are separate and their acts will not be attributed to the state. However, several exceptions qualify this principle: the separation will not be respected if the corporate veil has been created as a means for fraud and evasion.²⁴ Also, conduct will be attributed to the state in cases where the corporation exercises

¹⁸ At para 49. Footnotes omitted. In the same sense: *ADF v United States*, Award, 9 January 2003, para 166.

¹⁹ *Enron v Argentina*, Decision on Jurisdiction, 14 January 2004, para 32. See also the case of *Heirs of the Duc de Guise*, 15 September 1951, XIII RIAA 150, 161, in which the Franco-Italian Conciliation Commission held that the Italian state was responsible for the conduct of Sicily even though Sicily enjoyed a status of autonomy in Italian law.

²⁰ *Mondev v United States*, Award, 11 October 2002, para 67.

²¹ *Metalclad v Mexico*, Award, 30 August 2000, para 73; *Tokios Tokelés v Ukraine*, Decision on Jurisdiction, 29 April 2004, para 102.

²² See, generally, L Schicho, *State Entities in International Investment Law* (2012); Organisation for Economic Co-operation and Development (OECD), *Public Sector Modernisation: Changing Organisational Structures*, OECD Policy Brief (2004).

²³ In *CSOB v Slovak Republic*, Decision on Jurisdiction, 24 May 1999, paras 15 et seq, the legal status of the claimant as a foreign private party (as opposed to a state agency) was in dispute. See at pp 250–1.

²⁴ See International Court of Justice, *Barcelona Traction Case*, Judgment, 5 February 1970, ICJ Reports (1970) 3, 39, paras 56–8.

public power.²⁵ Another exception concerns a situation of ownership by the state where control is exercised in order 'to achieve a particular result'.²⁶

In general, matters of state responsibility, including attribution, are regulated in customary international law. Exceptionally, there are provisions in treaties that provide for the responsibility of states for action of their entities.²⁷ In *Genin v Estonia*,²⁸ this principle was reflected in a specific provision of the bilateral investment treaty (BIT). The Tribunal said:

The Bank of Estonia is an agency of a Contracting State. The Estonian central bank is a 'state agency', as defined by the BIT, which stipulates in Article II 2(b) that 'Each Party shall ensure that any state enterprise that it maintains or establishes acts in a manner that is not inconsistent with the Party's obligations under this Treaty wherever such enterprise exercises any regulatory, administrative or other governmental authority that the Party has delegated to it, such as the power to expropriate, grant licenses....' The Republic of Estonia is therefore the appropriate Respondent to a complaint relating to the conduct of the Bank of Estonia.²⁹

Matters of attribution governed by general international law include the question whether contracts or other acts undertaken by state entities are binding for the state that created those entities.³⁰ Questions have also arisen as to whether commitments undertaken by state entities can be considered to amount to jurisdictional consent

²⁵ See eg *Phillips Petroleum v Iran*, 21 Iran-US CTR 79 (1989).

²⁶ See J Crawford, *The International Law Commission's Articles on State Responsibility* (2002) 113, para 6; also *Foremost Teheran v Iran*, 10 Iran-US CTR 288 (1986); *American Bell v Iran*, 12 Iran-US CTR 170 (1986).

²⁷ ECT, Art 22 provides for special legal obligations of each state in regard to activities on the part of state enterprises:

(1) Each Contracting Party shall ensure that any state enterprise which it maintains or establishes shall conduct its activities in relation to the sale or provision of goods and services in its Area in a manner consistent with the Contracting Party's obligations under Part III of this Treaty. (2) No Contracting Party shall encourage or require such a state enterprise to conduct its activities in its Area in a manner inconsistent with the Contracting Party's obligations under other provisions of this Treaty. (3) Each Contracting Party shall ensure that if it establishes or maintains an entity and entrusts the entity with regulatory, administrative or other governmental authority, such entity shall exercise that authority in a manner consistent with the Contracting Party's obligations under this Treaty. (4) No Contracting Party shall encourage or require any entity to which it grants exclusive or special privileges to conduct its activities in its Area in a manner inconsistent with the Contracting Party's obligations under this Treaty.

It is reasonable to assume that under certain circumstances these obligations of the host state go beyond the requirements under customary law.

²⁸ *Genin v Estonia*, Award, 25 June 2001.

²⁹ At para 327.

³⁰ This area of the law is closely connected with the view that a state cannot invoke provisions of domestic law as a defence against the violation of an international obligation (see Vienna Convention on the Law of Treaties, Art 27). See also in this respect, the decision of the ad hoc Committee in *Vivendi v Argentina*, Decision on Annulment, 3 July 2002, at para 101-7 (emphasizing the distinction between issues of attribution and responsibility in view of the unclear reasoning of the first *Vivendi* decision). In *Perenco v Ecuador*, Decision on Jurisdiction, 30 June 2011, paras 182-219 a contractual clause was to be applied which defined the parties to the contract as 'the Ecuadoran State, through Petroecuador, and the Contractor'. The Tribunal concluded that Petroecuador had a separate legal personality, but this did not mean that Petroecuador became a party to that contract.

on the part of the state itself, and also whether actions taken by those entities must be attributed to the state when it comes to liability for violation of treaty rights and relevant rights of the investor under general international law. Considerations of state unity also arise when the state entity is the respondent and measures by the state affect the relationship between the foreign investor and the state entity.

(b) Structure, function, and control

The relevant rules of attribution,³¹ as found in general international law, are reflected in the ILC's Articles on State Responsibility.³² The Articles differentiate between conduct by organs of the state (see Art 4, quoted above) and other entities, which are empowered to exercise elements of governmental authority, in Article 5. That Article provides:

Article 5 Conduct of persons or entities exercising elements of governmental authority

The conduct of a person or entity which is not an organ of the State under Article 4 but which is empowered by the law of that State to exercise elements of the governmental authority shall be considered an act of the State under international law, provided the person or entity is acting in that capacity in the particular instance.

Whereas Article 4 refers to attribution on the basis of structure, Article 5 refers to attribution on the basis of function. Recent jurisprudence of the International Centre for Settlement of Investment Disputes (ICSID) reflects this terminology referring to a 'structural test' (corresponding to the rule in Art 4) and a 'functional test' (along the lines of Art 5).³³

Article 5 of the ILC's Articles covers the exercise of governmental authority by entities that do not fall into the category of 'organs of state'. The key term is 'governmental authority', and relevant cases will often turn on the meaning of this concept. The Commentary to the ILC's Articles adds the following explanation:

If it is to be regarded as an act of the State for purposes of international responsibility, the conduct of an entity must accordingly concern governmental activity and not other private or commercial activity in which the entity may engage. Thus, for example, the conduct of a railway company to which certain police powers have been granted will be regarded as an act of the State under international law if it concerns the exercise of those powers, but not if it concerns other activities (e.g. the sale of tickets or the purchase of rolling-stock).³⁴

³¹ On the development of the law, see K H Böckstiegel, 'Arbitration and State Enterprises' (1985) 1 *Arbitration International* 195.

³² See eg *Noble Ventures v Romania*, Award, 12 October 2005, para 69.

³³ For a different understanding of these terms, see *LESI v Algeria*, Award, 12 November 2008, paras 106 et seq.

³⁴ J Crawford, *The International Law Commission's Articles on State Responsibility* (2002) 101. In *LESI v Algeria*, Award, 12 November 2008, the Tribunal examined, in paras 102 et seq, not just whether the entity in question exercised governmental functions and whether the act in question was of a governmental nature, but also whether the act was to be attributed in view of the specific complaint under the relevant standard of protection. On the need to consider (a) not only the powers of the entity in general, but (b) also the specific act in question, see *Jan de Nul v Egypt*, Award, 6 November 2008, paras 163–71 and *Hamester v Ghana*, Award, 18 June 2010, paras 202 et seq.

For the purpose of determining what is 'governmental', the ILC Commentary proposes to rely on the particular society and its traditions.³⁵ An alternative approach would be to focus on a comparative standard and to consider, from an objective point of view, what is normally regarded as 'governmental authority' in a contemporary setting. The formal designation in the particular domestic legal system should not be decisive. However, the manner in which the entity is empowered by the state, the content of the powers conferred, and the links between the entity and the state organs must be considered in the context of each case.

In addition to structure and function, the ILC Articles also use the criterion of state control over the entity. Article 8 of the Articles provides:

Article 8 Conduct directed or controlled by a State

The conduct of a person or group of persons shall be considered an act of a State under international law if the person or group of persons is in fact acting on the instructions of, or under the direction and control of, that State in carrying out the conduct.

The Commentary to the ILC Articles explains that 'where . . . the State was using its ownership interest in or control of a corporation specifically in order to achieve a particular result, the conduct in question has been attributed to the State'.³⁶

Therefore, attribution to the state of conduct under the 'direction or control' of the state requires not only that the entity is generally controlled by the state but that the individual operation in question was effectively controlled and that the act was a genuine part of that operation.

Key terms of the Articles were drafted with a broad brush in general terms, leaving their application to tribunals addressing specific factual settings. Thus, simple reference to the text of the Articles cannot replace an appropriate analysis and explanation of the manner in which the specific setting of the case has to be understood in light of the Articles. In specific cases, the text of the Articles may have to serve as the starting point rather than the end of the reasoning.

It has been pointed out that the levels of control required for attribution under Article 8 in the context of an investment dispute may differ from the standard applied in other areas of international law, such as in the laws on armed intervention or international criminal responsibility.³⁷

(c) Judicial practice on attribution

In practice, tribunals have often used a combination of the criteria of structure, function, and control.³⁸

³⁵ J Crawford, *The International Law Commission's Articles on State Responsibility* (2002).

³⁶ Crawford, n 35, pp 112–13.

³⁷ See *Bayindir v Pakistan*, Award, 27 August 2009, para 130.

³⁸ For a detailed overview of tribunal practice, see J Crawford, 'Investment Arbitration and the ILC Articles on State Responsibility (with Appendix)' (2010) 25 *ICSID Review* 127.