

INTERNATIONAL COMMERCIAL  
ARBITRATION  
AND STATE CONTRACTS

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**TO THE MEMORY OF MY FATHER**

**AND TO MY MOTHER**

**I DECLARE THAT THIS THESIS IS ENTIRELY MY OWN  
WORK**

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## ABSTRACT

Whether international commercial arbitration is appropriate as a method of state contracts dispute settlement is the main question of this thesis. State contracts are different from ordinary commercial contracts, in that, due to the sovereign status of one party and the involvement of public interest, there is a need, recognised by municipal law and international law, for the flexibility in contractual relations.

The ability of international commercial arbitration to respond to various needs of international trade have no doubt been among factors contributing to its popularity with the main recipient of its service i.e. the international business community. In particular, the law and practice of international commercial arbitration in popular seats of arbitration have considerably promoted the stability of contractual relations much desired by the business community. Such strong support for the stability of contractual relations is also in line with the broad economic interests of these countries. It is, however, submitted that this overall commitment by international commercial arbitration to the stability of contractual relations is not compatible with the flexibility requirement of state contracts.

This work follows a classical structure, in that, various aspects of arbitration including jurisdictional issues, questions of control and procedural remedies, substantive law, remedies and recognition and enforcement of awards will be studied. More specifically, the effects of the developments in national laws and arbitral practice on the arbitration of state contracts will be considered. As well as international commercial arbitration, this work will cover other types of state contracts arbitrations including treaty-based arbitrations such as those conducted within the regimes of the ICSID and the Iran-US Claims Tribunal.

## Abbreviations

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AAA	American Arbitration Association
AC	Appeal Cases (U.K.)
AJCL	American Journal of Comparative Law
AJIL	American Journal of International Law
All E.R.	All England Law Reports
Arb.Int.	Arbitration International
ASIL	American Society of International Law
BIT	Bilateral Investment Agreement
BYIL	British Yearbook of International Law
Cath.U.L.Rev.	Catholic University Law Review
CERDS	Charter of Economic Rights and Duties of States
CIETA	China International Economic and Trade Arbitration
CMEA	Council for Mutual Economic Assistance
Columb.J.Transnational law	Columbia Journal of Transnational Law
Cornell L.Q.	Cornell Law Quarterly
Duke L.J.	Duke Law Journal
EU	European Union
FDI	Foreign Direct Investment
Harv.Int'l.L.J.	Harvard International Law Journal
ICC	International Chamber of Commerce
I.C.J.	International Court of Justice
ICLQ	International and Comparative Law Quarterly
ICSID	Interantional Centre for Settlement of Investment Disputes
ICSID Rev-FILJ.	ICSID Review- Foreign Investment Law Journal
IJIL	Indian Journal of International Law
ILM	International Legal Material
ILR	International Law Report
Iran-US C.T.R.	Iran-United States Claims Tribunal Reports
J.Int'l Arb.	Journal of International Arbitration
LLR	Lloyds Law Reports
LMCLQ	Lloyds Maritime and Commercial Law Quarterly
LQR	Law Quarterly Review

JBL	Journal of Business Law
JWTL	Journal of World Trade Law
JWT	Journal of World Trade
NIEO	New International Economic Order
NYIL	Netherlands Yearbook of International Law
OECD	Organisation for Economic Cooperation and Development
P.C.I.J.	Permanent Court of International Justice
QB	Queen's Bench Reports
RBDI	Revue Belge de Droit International
RIAA	Reports of Interantional Arbitral Awards
Tex.Int'l.L.J.	Texas International Law Journal
Tul.L.Rev.	Tulane Law Review
UN	United Nations
UNCITRAL	United Nations Commission of Interantional Trade Law
UNTS	United Nations Treaty Series
Va.J.Int'l.L.	Virginia Journal of International Law
Va.J.Trans.L.	Virginia Journal of Transnational Law
WLR	Weekly Law Reports
YBCA	Yearbook Commercial Arbitration
YBILC	Yearbook of International Law Commission

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# Chapter I

## General

### 1.1 Introduction

The growing interdependence of the world economy is creating more and more opportunities for transnational business transactions. The value of world trade in 1993 was estimated to reach \$ 8 trillion indicating a growth rate of 5.7% a year on average between 1984 and 1993.<sup>1</sup> Parallel to this, a sharp rise can be seen in the level of foreign direct investment (FDI).<sup>2</sup> This is to a large extent due to the new economic policies followed by the ex-socialist countries. On the one hand, they have opened their markets to foreign imports and, on the other, because of a lack of resources in capital and modern technology, have welcomed foreign investment.<sup>3</sup> Furthermore, developing countries across the world, having gone through a period in which they adopted a generally negative approach towards foreign investment, once again see it as a likely solution to their development needs.<sup>4</sup> At the time of the expansion of the free market economy, questions arise as to the role of free market concepts in national and international economic systems and the legal rules regulating such systems.<sup>5</sup>

States with both mixed and controlled economies play an active role in transnational economic activities including foreign trade and investment. Generally speaking, state contracts can be described as the legal form of transactions between states and private parties in a transnational setting.<sup>6</sup> Disputes arising out of state contracts were

<sup>1</sup> Rohwer, J., What's in a nationality, In *The World in 1993*, The Economist Publication 1993, 11 at 12.

<sup>2</sup> *Ibid.* A recent study describes the recent growth in the level of global foreign direct investment as follows: "Following the recession of 1981-82, the global flow of FDI grew at the unprecedented rate of almost 30 per cent per year, on average, through the remainder of the decade. The rate of growth corresponds to three to five times the growth rate of the end of the decade, the annual FDI flow was about US\$200 billion, an amount three to four times the average annual flow during the decade 1975-1984. While total FDI outflows fell from some US\$234 billion in 1990 to roughly US \$180 billion in 1991 and US \$ 150 billion in 1992- due largely to the growth slowdown in the OECD economies, and especially to a drop in the flow of FDI to the United States- the global stock of FDI continued to grow faster than global trade and output." *OECD Report: Foreign Direct Investment: OECD Countries and Dynamic Economies of Asia and Latin America*, Paris:OECD Publications 1995, 60.

<sup>3</sup> See study of foreign investment in a number of such countries see Dobosiewicz, Z., *Foreign Investment in Eastern Europe*. London/New York: Rutledge 1992.

<sup>4</sup> Walde, T. W., Investment Policies and Investment Promotion in Mineral Industries, (1991) 6 ICSID Rev.-FILJ 93 at 94-99.

<sup>5</sup> Horn, N., Codes of Conduct for MNEs and Transnational Lex Mercatoria: An International Process of Learning and Law Making, In *Legal Problems of Codes of Conduct for Multilateral Enterprises*, Deventer: Kluwer 1980, 45 at 50-1.

<sup>6</sup> See, *infra*, 1.2.

traditionally adjudicated before the national courts of the state party. In cases when such courts did not provide sufficient remedies for the foreign private party a denial of justice occurred which was then, subject to certain conditions, a basis for a claim in international law for the home state of the private party.<sup>7</sup> Such cases were covered by the branch of international law concerning state responsibility for injuries to aliens.<sup>8</sup> Tribunals dealing with such cases were interstate arbitral tribunals established following the conclusion of an agreement between the state parties.<sup>9</sup> Private parties had to pursue their claim against foreign states through the intervention of their respective states. The discretionary nature of a state's intervention and the inadequacy of the law of state responsibility in matters relating to the protection of foreign investment lead foreign investors to search for alternative methods of dispute settlement with states.<sup>10</sup> Arbitration, in this context, is one such alternative. The practice of inserting arbitration clauses in contracts between states and foreign private parties, which started mainly in the field of foreign investment contracts, is relatively recent.<sup>11</sup>

The main form of arbitrations stipulated by investment agreements were *ad hoc*, as opposed to institutional. Such arbitrations, in some respects, were similar to interstate arbitrations in that arbitral tribunals often resorted to international law on questions of procedure and substance.<sup>12</sup> However, what today is commonly referred to as international commercial arbitration is the kind of arbitration which developed mainly within the context of national law. The present work is primarily concerned with the resolution of state contracts disputes through international commercial arbitration. This

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<sup>7</sup> See in general Borchard, E., *Diplomatic protection of citizens abroad*, New York:Kraus 1927; Garcia-Amador, F. V., *The Changing Law of International Claims*, New York:Oceana 1984.

<sup>8</sup> *Ibid.*

<sup>9</sup> *Ibid.*

<sup>10</sup> On the power of states to extend diplomatic protection to nationals and to companies incorporated under their laws see *Barcelona Traction Light and Power Company, Limited (Belgium v. Spain)* where it was held that "[t]he State must be viewed as the sole judge to decide whether its protection will be granted, to what entities granted and when it will cease." 1970 ICJ (Judgment of Feb. 5, 1970) para. 79.

<sup>11</sup> *Lena Goldfields v. USSR* in Nussbaum, *The Arbitration Between the Lena Goldfields Ltd. and the Soviet Government*, (1950) 36 Cornell L.Q. 31-36; *Petroleum Development Ltd. v. The Sheikh of Abu Dhabi*, The Decision of the Umpire September 1951 (1951) 18 ILR 144 at 149; *Ruler of Qatar v. International Marine Oil Company* (1953) 20 ILR 534 at 545; *Sapphire International Petroleum Ltd. v. National Iranian Oil Company* (NIOC), Award of 15 March 1963, 35 ILR 137 at 170-6; *Texaco Overseas Petroleum Company and California Asiatic Oil Company v. The Libyan Arab Republic*, Awards of 27 November 1975 and 19 January 1977 (Merits), 53 ILR 389 at 453.

<sup>12</sup> E.g. in *Aramco*, the tribunal held that the procedure of arbitration was subject to international law. *Saudi Arabia v. Arabian American Oil Company (Aramco)*, Award of 23 August 1958, 27 ILR 117 at 155-6.

chapter will focus on the definition of the elements of the topic and major relevant issues.

## 1.2 State Contracts

It has been maintained that: "[t]he demarcation between the traditional political functions of state and the modern economic activities of state has often become blurred, and it is in this borderline that state-trading flourishes."<sup>13</sup> At the present scale, state participation in international economic activities is a phenomenon of this century. State activities in this area have a dual function; public and private. Contracts in which one party is a state or a state entity are one principal legal form of the transactions in a transnational setting. They cover various areas such as public works, transportation, natural resources, etc. Since a great majority of such contracts involve direct foreign investment, a brief study of the recent evolution in the setting and characteristics of foreign investment transactions will be of value.

### 1.2.1 General Context

Historically, concession agreements were often concluded between the government of a developing country and a citizen or private enterprise of a western industrialised country.<sup>14</sup> Such agreements normally involved the exploitation of natural resources or rendering a public service for a long duration of time within an allocated area by a

<sup>13</sup> Sucharitkul, S., *State immunities and trading activities in international law*, London : Stevens, 1959 at 19 (footnote omitted). See in general Kostecki, M.M., *State trading in international markets : theory and practice of industrialised and developing countries*, edited book, London : Macmillan, 1982.

<sup>14</sup> Due to the diversity of forms in which such agreement have appeared it has been rather difficult for writers to define concession agreements. A recent study on concession agreements notes: "It is universally acknowledged that it is difficult to define the term "concession". Legal writing and jurisprudence have adopted divergent definitions and tended to shift their emphasis over time. One writer regarded the concession as "a privilege granted by a government to an individual or group, of developing certain resources or of constructing certain public works". In a more recent study on the legal aspects of oil concessions, the author maintained that: "a concession is the grant of a privilege, usually exclusively but not necessarily so, to conduct an economic enterprise for a defined period and usually within a defined area." Gao, Z., *Petroleum Contracts: Current Trends and New Directions*, London/Dordrecht/Boston:Graham and Trotman/Martinus Nijhoff 1994, 12; For a historical study of various state contracts in the field of international investment see Kuusi, J., *The host state and transnational corporation: an analysis of legal relationships*, Farnborough: Saxon House 1979.

foreign national in return for the payment of royalties.<sup>15</sup> The regime of such agreements was stabilised for the whole period of the concession, in that, they were primarily designed to protect the interest of the private party i.e. the investor.<sup>16</sup> Often, the overall role of such agreements on the national economy was ignored as many of the host states lacked any coherent national economic policy against which the foreign investment plans could be appraised.<sup>17</sup>

Since many such concessions were granted under direct or indirect colonial influence, they were resented by many in those countries; they were viewed as a means of gaining control by the home state of the foreign investor over the political and economic life of the host state.<sup>18</sup> The beneficial aspects of foreign investment were doubted as often investment agreements embodied unfair bargains and as such were viewed as barriers to economic independence and development.<sup>19</sup> The dependency theory of foreign investment, which considers any kind of foreign investment detrimental to the interest of the home state, is largely rooted in the past experience of many of the developing countries, in particular those of Latin America, and the attitudes formed thereof.<sup>20</sup> The movement for economic and political independence was traditionally hostile to foreign investment. Based on this negative feeling towards

<sup>15</sup> In the field of petroleum industry, the major features of such agreements were:

- "(1) a large concession area with no relinquishment provision;
- (2) long duration with no revision possibility;
- (3) exclusive rights to foreign companies to all facets of petroleum operations;
- (4) property rights to foreign companies in the petroleum resources;
- (5) exemption from all taxes and custom duties;
- (6) modest royalty paid on oil production volume; and
- (7) transfer of property to governments upon expiry of concessions."

Gao, *supra*, note 14 at 13; also Hossain, K., and S. Chowdhury, *Permanent Sovereignty over Natural Resources in International Law*, London: Frances Pinter Publishers Ltd. 1984, Introduction.

<sup>16</sup> See, in general, Fischer, P., *A Collection of International Concessions and Related Instruments*, London. Rome. New York: Oceana Publications.

<sup>17</sup> Sornarajah, M., *The International Law on Foreign Investment*, Cambridge: Cambridge University Press 1994, 43-5.

<sup>18</sup> *Ibid.* at 43-5; Asante, S., *Restructuring Transnational Mineral Agreements*, (1979) 73 AJIL 335.

<sup>19</sup> According to the famous D'Arcy Concession May 28, 1901, D'Arcy was given the exclusive privilege to carry out all petroleum exploration and other related activities throughout Iran (then Persia) for a period of 60 years. In return, D'Arcy paid the government a small bonus and 16 percent of the company's annual profits. Agreement between the Government of His Imperial Majesty, the Shah of Persia and W.K.D'Arcy, in the League of Nations, Official Journal, XIII, 1932, pp.305-507.

<sup>20</sup> See contributions in Seers, D., *Dependency theory: a critical reassessment*, edited book, London: Pinter 1981; Blomstrom, M. and B. Hettne, *Development theory in transition: the dependency debate and beyond: Third World responses*, London: Zed, 1984.

foreign investment, a wave of nationalisations swept across Eastern Europe and some independent developing countries after World War II and later in the 1960s and the 1970s, in the newly independent countries of Third World.<sup>21</sup> Furthermore, developing countries concentrated their efforts within the U.N. framework in voicing their opposition to the existing economic order, as the product of a past colonial rule and exploitation of the weak by the strong. They called for a new international economic order based on equity, sovereign equality and interdependence of the developed and developing countries.<sup>22</sup> In particular, they maintained that political and economic independence were inseparable and both were parts of the sovereignty of states. In the area of natural resources they asserted the principle of permanent sovereignty to justify, among other things, the termination or modification of 'inequitable' concessions.<sup>23</sup>

The emergence of transnational corporations which conduct the bulk of foreign direct investment and the assumption by the host state of greater responsibilities in relation to the economic life of the nation has transformed the setting of state contracts relating to foreign direct investment. Transnational corporations, unlike the traditional foreign investors, follow a predominantly global model in their strategies, management and operation.<sup>24</sup> The enormous resources of finance and skills that such corporations have at their disposal give them a great potential to assist the developing countries in the pursuit of their development. On the other hand, states in pursuit of political and economic independence and development have tended to adopt an interventionist role with regard to economic activities. This role could amount to almost total control of the economy or could be restricted to partial control through introducing broad economic policies and the necessary regulatory measures for their implementation. Generally speaking, the phenomenon of state trading reflects the position of states regarding their

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<sup>21</sup> Walde, *supra*, note 4 at 94.

<sup>22</sup> Resolution 1803 (XVII) on Permanent Sovereignty over Natural Resources 1962, 17 UN GAOR Supp. (No. 17), UN Doc. A/5217 (1962), reprinted in (1963) 2 ILM 233; Resolution 3171 (XXVIII), 28 UN GAOR Supp. (No. 30), UN Doc. A/9030, reprinted in (1974) 13 ILM 238; Resolution 3281 (XXIX) known as the Charter of Economic Rights and Duties of States 1974, 29 UN GAOR Supp. (No.31), UN Doc. A/9631 (1974), reprinted in (1975) 14 ILM 251; for commentary see Hossain, K., *Legal Aspects of the New International Economic Order*, Frances Pinter (Publishers) Ltd.: London 1980.

<sup>23</sup> Hossain, *ibid.* at 2.

<sup>24</sup> Kuusi, *supra*, note 14 at 26-28.

foreign trade and investment whereby they maintain a degree of control over essential terms of the related contract/s in order to secure certain economic policy objectives.<sup>25</sup>

The view of capital importing countries towards transnational corporations is a mixed one. On the one hand, based on their recognition of the growing economic interdependence and globalisation of trade and investment, and the relevant capabilities offered by transnational corporations in these areas, they realise the potential assistance that such corporations could offer. On the other hand, the sheer power of transnational corporations as a basis for their strong bargaining position and the fact that their policies could be influenced by policies of the states where they have their headquarters, often has <sup>ve</sup> been viewed by the developing countries as a threat to their sovereignty.<sup>26</sup> As regards the effects of the global policy of transnational corporations on the ability of governments to control national economies, it has been maintained that:

Economic growth largely depends on the level of investment in a country. If the reinvestments of profits by foreign subsidiaries constitute a significant part of the annual investment in the whole economy, or, which is more likely, of the investments in the export industries, the rate of economic growth and foreign exchange earnings of the country will be directly affected by the global policies of the transnationals concerned. The measures restored to by the transnationals influence the general economic-monetary, fiscal, balance-of-payments and employment- stability of the countries in which they operate.<sup>27</sup>

Host states, developed and developing, are often concerned about “the abusive transfer pricing, tax evasion, depression of domestic enterprises, improper interference in internal political affairs, sometimes down right subversive, ineffectual or inappropriate transfer of technology, corruption of public officials, harmful advertising practices and restrictive business practices.”<sup>28</sup> In the light of the above considerations, states at times have concluded that foreign investment was not beneficial to their politico-economic interests.

In recent years, however, this fear has to some extent diminished. Thus there has

<sup>25</sup> “State trading occurs when a government or a government backed agency determines the essential terms (including prices and quantities) on which exports and imports have to take place.” Kostecki, *supra*, note 13 at 6.

<sup>26</sup> Kuusi, *supra*, note 14 at 26-7.

<sup>27</sup> *Ibid.* at 26- 27(emphasis added by the author).

<sup>28</sup> Asante, S., *International Law and Foreign Investment*, (1988) 37 ICLQ 586 at 618-19.

been a shift of attitude among many states in favour of foreign direct investment.<sup>29</sup> Among the factors contributing to this shift of attitude are the adoption of new economic policies by developing countries, the improved bargaining position of the host states viz-a-viz transnational corporations, and the successful model of foreign-investment-based development in a number of countries.

The pattern of economic development pursued by many developing countries has changed from import substitution to being export-oriented.<sup>30</sup> This has created a new demand for these countries in terms of access to foreign markets.<sup>31</sup> Given their market share and distribution networks, the transnational corporations are well positioned to meet this demand.

The host states concern over certain aspects of the operation of transnational corporations was the basis of national and international efforts aimed to regulate the conduct of such corporations. These efforts have resulted in promulgation of regional and international codes of conduct on transnational corporations by the OECD and the UN.<sup>32</sup> The relevant UN and OECD organs also serve as clearing houses for Third World governments seeking to regulate or negotiate with multinationals and OECD.<sup>33</sup> The economic changes resulting from the decline of communism in Eastern Europe and the adoption of open policy toward foreign investment by China have acted as a proof of difficulties involved in the non-market patterns of development. For example, a recent study in Eastern Europe comes to the conclusion that all governments of that region are now strongly supportive of foreign investment.<sup>34</sup> Furthermore, the foreign investment-based economic success of the newly industrialised countries of South East

<sup>29</sup> See the OECD Report, *supra*, note 2, chapter II.

<sup>30</sup> *Ibid.* at 62-3.

<sup>31</sup> See Sornarajah, *supra*, note 17 at 17.

<sup>32</sup> On the legal regime and binding effect of the codes see Horn, N., *Legal Problems of Codes of Conduct for Multilateral Enterprises*, *supra*, note 5.

<sup>33</sup> Dickse, R. and Layman, T.A., *Foreign Investment and Government Policy in the Third World*, London: Macmillan Press 1988, 6.

<sup>34</sup> See Dobosiewicz, *supra*, note 3 at 25. As an example of the strong desire of these countries for foreign investment the author quotes Lech Walesa's following statement: "As for Poland, we need foreign investment because it ... gives us security. Having a Frenchman or an Englishman here with his factory is like having a division of troops. You in the West have over-production. You can make money out of our shortages and our stupidity - and we have plenty of that."

Asia has made them a model for other developing countries.<sup>35</sup> It has, to some extent, neutralised the traditional hostilities felt in many developing states toward foreign investment. Indeed, there now is a flow of foreign investment between developing countries themselves.<sup>36</sup>

The adoption of a more favourable approach towards foreign investment by developing countries has been accompanied by various control measures regarding the scope and regime of foreign investment.<sup>37</sup> These measures are normally introduced by foreign investment codes which function as incentives to attract foreign investment and also provide for a regulatory regime of foreign investment.<sup>38</sup> Such a regime often provides a wide variety of measures including, among others, screening of foreign investment entry, requirements of local collaboration, capitalisation requirement, provisions relating to environmental protection and limitation on the type of contractual arrangements.<sup>39</sup> The new types of arrangements aim to meet the interests of the host country, in particular the changing demands of public interest, and thus are necessarily adjustable to prevailing conditions.<sup>40</sup> Joint venture and production sharing agreements are two major forms of new contracts which are generally more amenable to public control than the previous concession agreements, in that, they are more in the nature of public than commercial contracts.<sup>41</sup>

<sup>35</sup> For example, the flow of investment between the newly industrialised countries of South East Asia and China, Thailand and Malaysia can be mentioned. See The OECD report, *supra*, note 2 at 13.

<sup>36</sup> It has been noted that: "Intra-regional links are also developing quite rapidly within the "Chinese Economic Area" formed between Taiwan, Hong Kong and certain provinces in southern China, Hong Kong accounted for 60 per cent of total direct investment to China at the end of 1990, including investment by foreign subsidiaries located in Hong Kong (mainly from Taiwan). Taiwan is the fourth largest investor behind Hong Kong, the US and Japan. Another notable development is the increasing importance of China as a source of FDI to Hong Kong; it now appears to be the primary investor to Hong Kong, ahead of Japan and the United States." *Ibid.*

<sup>37</sup> An opinion poll in Poland indicates that the popular support for the attraction of foreign capital does not equally extend to all sectors of the economy. In particular, privatisation in areas of land, printed media and natural wealth do not enjoy the same support as other areas. Dobosiewicz, *supra*, note 3 at 25.

<sup>38</sup> For a study of different approaches adopted by a number of developing countries on the admission of foreign investment see Parra, A.R., Principles Governing Foreign Investment, as Reflected in National Investment Codes in Shihata, I., *Legal Treatment of Foreign Investment: The World Bank Guidelines* 311. Edited book, Dordrecht/London: Nijhoff at 312-318.

<sup>39</sup> For a detailed study of measures of control by the host state see, Somarajah, *supra*, note 17, Chapter III.

<sup>40</sup> In the area of petroleum agreements see El-Kosheri, A.S. and Riad, The law governing a new generation of petroleum agreements: Changes in the arbitration process. (1986) 1 ICSID Rev.-FILJ 225; El-Chiati, A., Protection of investment in the context of petroleum agreements. (1987) 204 RCADI 9; Gao, *Petroleum Contracts: Current Trends and New Directions*, *supra*, note 14.

<sup>41</sup> Somarajah, *supra*, note 17 at 115.

In the light of the above, a theory of foreign investment may be formulated according to which states' views of foreign investment are determined on a case-by-case basis based on the 'national circumstances' involved and the 'terms and conditions' of a particular project.<sup>42</sup> The national circumstances could refer to a host of parameters including the setting up of legal infrastructure and of a proper administration of foreign investment and the elimination of corrupt practices in the relevant areas to ensure the protection of economic, political and also cultural autonomy of the state and the contribution of the investment to its development objectives.<sup>43</sup> Therefore, a balance between, on the one hand, the interest of the transnational following its global policy of the maximisation of profits, sales, market share, and other privately-oriented goals and on the other hand, the interest of state in pursuit of national political, economic independence and development is the corner stone of the contemporary foreign direct investment. State contracts relating to foreign investment transactions therefore represent two distinct and conflicting interests i.e. the private interest of transnational corporations and the public interest of the host state. Indeed, it is the reconciling these conflicting interests which forms the framework of the international controversy regarding state contracts:

The heart of the international controversy is the conflict between the state's predominant concern and responsibility for the country and people over which its sovereignty extends, and the interests of the foreign investor in the reasonable protection of his investment and economic expectation.<sup>44</sup>

### 1.2.2 Legal Nature of State Contracts

What is the legal nature of contracts involving a state acting in pursuit of public interest and a private enterprise? Are they public, private or mixed in nature?

The characterisation of such contracts is relevant to the question whether the state

<sup>42</sup> "... whether a particular foreign private investment project will contribute to the social and economic development of the host country cannot be answered *a priori* but only after a thorough investigation of the national circumstances involved and the terms and conditions laid down for the project. The effects of investments by foreigners have to be reviewed in the light of the development objectives of the host country and the implications of foreign investment for the growth and distribution of income, for the employment opportunities, for the absorption of new skills and technology and for the balance of payments of the country, have to be examined and carefully evaluated." Kuusi, *supra*, note 11 at 41.

<sup>43</sup> Dickie, R. and Layman, T.A., *supra*, note 33 at 2.

<sup>44</sup> Friedmann, W., *Changing Structure of International Law*, London: Stevens and Sons 1964, 201.

party may enjoy certain privileges. It has been argued that the 'sovereign quality' of the state party and the 'public interest' element involved in such contracts form the basis for certain privileges for that party with regard to the contract regime; namely the powers to unilaterally modify or terminate its contracts.<sup>45</sup> It is further argued that the exercise of such powers is in pursuance of both authority and duty of the state as part of its "responsibility to the public."<sup>46</sup> This special position of states renders their contracts with private parties as those between unequals.

In a municipal law context, the special privileges of states with regards to their contracts is often seen in the division between public and private law contracts. Public law is concerned with the relations between unequals whereas private law regulates relations between parties of equal status. The underlying rationale for such a division is the recognition of the involvement of public interest in contracts of public authorities as the basis of the inequality between the parties and the predominance given to the protection of that interest. Following Radbruch's understanding of the distinction between public law and private law, Pound states:

In the positive law this distinction, we are told, corresponds to a contrast between "the coordinating law", which secures interests by reparation and the like, treating all individuals as equal, and "subordinating law", which prefers some or the interests of some to others according to its measure of values ... Public law, he continues, is a "law of subordination", subordinating individual to public interests and identifying some individual interests but not the interests of other individuals with those public interests. Moreover, as he sees it, all "coordinating law", that is, law coordinating individual interest by treating individuals as equal, gets its force from the "law of subordination", which identifies with public interests the interests coordinated, and hence public law has primacy over private law, subordination of individual interests over coordination of them. The primacy of public law is a primacy of state established law. Public or subordinating law proceeds from the state and private law depends upon it"<sup>47</sup>

On the nature of state contracts, arguments range from those which consider state contracts as private in nature allowing for no extra-contractual power for states to those which consider them purely public. There is also a middle characterisation which considers state contracts as hybrid with both private and public law features. The matter should be looked at within the context of the relevant legal orders.

<sup>45</sup> Maniruzzaman, A. F. M., *State Contracts with Aliens: The Question of Unilateral Change by the State in Contemporary International Law*, (1992) 9 *J.Int.Arb.* 141 at 145; Friedmann, *ibid.*

<sup>46</sup> *Ibid*

<sup>47</sup> Pound, R., *Public Law and Private Law*, (1939) 24 *Cornell Law Quarterly* 469 at 471-2 quoting Radbruch (footnote omitted).

### 1.2.2.1 Municipal Law

The qualitative difference between government and private contracts has been recognised by various legal systems. In relation to government contracts, the consensual character of contract is limited on the ground of public interest.<sup>48</sup> Such limitations may be based on the recognition of the special status of states in the constitution such as the Taking Clause of the U.S. Constitution<sup>49</sup> or part of a regime of administrative contracts like the one in French law.<sup>50</sup>

In France, public law is based on the fundamental difference between the sovereign state and private persons. A great number of Government contracts are governed by a different legal regime from that of civil contracts. The administrative contracts regime is based on the recognition of the fact that the proper functioning of a government in matters relating to public welfare is not possible under the private law of contract. Public policy may require "a flexibility in contractual performance, to allow for changing demands of public interest".<sup>51</sup> The "inequality of interests" of the parties is the ground for qualifying the "consensual character" of the contract by giving one party the power to modify its obligations.<sup>52</sup> The source of this power is public policy and not the agreement of the parties. State contracts can be governed by two different legal regimes: civil and administrative contract regimes. The classification is made either by law or by the courts. Some contracts, due to their importance, are considered as administrative by law (*contrats administratifs par détermination de la loi*) which, according to statutory provisions, are within the jurisdiction of the administrative courts.<sup>53</sup> Where there is not such an expressed classification by law, courts have to answer the preliminary question as to the nature of the contract. The criteria employed may be the presence of clauses which are not normally found in private contracts (*clauses exorbitantes du droit commun*), or it may depend on the substantive nature

<sup>48</sup> See generally Turpin, C. C., Public Contracts, In *International Encyclopedia of Comparative Law*, Edited by A. Von Mehren, 1980, Ch. 4 ; Mitchel, J. D. B., *The Contracts of Public Authorities*, London: Bell, London School of Economics and Political Science 1954.

<sup>49</sup> "Nor shall private property be taken for public use, without just compensation."

<sup>50</sup> See in general Nicholas, B. *French Law of Contract*, 2nd ed., Oxford: Clarendon Press 1992.

<sup>51</sup> Turpin, *supra*, note 48 at 27.

<sup>52</sup> *Ibid.* at 28.

<sup>53</sup> *Ibid.*

and *object* of the contract.<sup>54</sup> As mentioned, the executive has the power to interfere with its contracts and ordinary courts do not have jurisdiction over such acts of State.<sup>55</sup> This however does not mean that the executive is totally free from any form of control. The *Conseil d'état* is an organ of the State which, in controlling the executive, functions in the same manner as ordinary courts.<sup>56</sup>

In English law, there is no separate legal regime for contracts of the State; the ordinary private law of contract applies.<sup>57</sup> However, the law recognises the difference between contracts of states and private contracts in the sense that it grants the state the power to interfere with the contract where the essential interests of the public so requires. This was recognised in the frequently-cited case *Amphirite v. the King*:

... the Crown cannot by contract hamper its freedom of action in matters which concern the welfare of the State.<sup>58</sup>

There are remedies available to private contractors against the effects of the government interfering with contractual rights. Such remedies are enforced through the judiciary and not through any special administrative courts. The courts in such cases may not grant any injunction or order of specific performance but they may make a declaratory judgment.<sup>59</sup>

In the United States, in principle, the ordinary private law of contract consisting of Federal Statute, regulations and case law apply to contracts of the state.<sup>60</sup> There is no concept of an administrative contract regime in US law. The rules relating to formation, interpretation and effect of contracts are the same for public and private

<sup>54</sup> Turpin, *supra*, note 48 at 28-29

<sup>55</sup> For a more detailed study of such grounds including doctrines of the *fait du prince* and *imprévision* see Turpin, *ibid.* at 40; also Maniruzzaman, *supra*, note 45 at 152-155.

<sup>56</sup> Nicholas, *supra*, note 50 at 24-6.

<sup>57</sup> See in general Mitchel, *supra*, note 48.

<sup>58</sup> (1921) 3 K.B. 500. Daintith compares the treatment by the U.K. and Norwegian Governments of their agreements with oil companies and their OPEC counterparts and concludes that they "are no more willing ... to stick rigidly to contracts that they deem unreasonably disadvantageous and that there is no absolute constitutional protection in either country for the principle of *pacta sunt servanda*." As an example of state intervention in its contractual obligations the Petroleum Submarine Pipeline Act of 1975 may be mentioned. It made substantial changes in the terms of production licences without compensation. Daintith, T., *Pacta sunt servanda* and the Licensing and Taxation of North Sea Oil Production, Oslo:Universitetet: Oslo Nordisk Institute for Sjorett 1978 at 29.

<sup>59</sup> Crown Proceeding Act of 1947, ss.1, 21.

<sup>60</sup> See in general Epstein, R. A., *Taking: Private Property and The Power of Eminent Domain*, Cambridge, Massachusetts/London:Harvard University Press 1985.

contracts.<sup>61</sup> There is however a system of principles which are applied for the disputes between government and private contractors.<sup>62</sup> Constitutional provisions relating to contractual obligations and their protection can be found in the Contract Clause, "No State shall ... pass any Bill of Attainder, *ex post facto* law, or law impairing the Obligations of Contracts"<sup>63</sup>, and in the Fourteenth and Fifth Amendments whereby "No person shall be denied of life, liberty or property, without due process of law; nor shall private property be taken for public use, without just compensation." Despite all the protection given to contractual rights where the fundamental interests of the public are involved, the State can override its contractual obligations based either on its 'police power' on the grounds of "the safety, health, morals, and general welfare of the public"<sup>64</sup> or according to the 'public use' requirement.<sup>65</sup> On the difference between the two grounds, Epstein maintains:

"... the reference to the "general welfare" of the people invites confusion between the police power and the distinct public use requirement, with their very different consequences. Meeting the public use limitation does not allow the state to take private property without just compensation. Satisfying the police power limitation, in contrast, does allow the State to take without compensation. The police power cannot be interpreted as an unrestricted grant of state power to act in the public interest, for then the exception will overwhelm the clause."<sup>66</sup>

According to the principle of government effectiveness a governmental agency is allowed to fulfil its fundamental purposes even if that would amount to interfering with the vested contractual rights of the individual.<sup>67</sup> The exercise of such power may be subject to judicial review. Therefore, in the United States there is power in the State which stands beyond the Contract Clause and the Fourteenth Amendment, but the arbiter of the validity of the exercise of this power is the judiciary and not the legislator which makes the claim.<sup>68</sup>

From the above, it is evident that municipal laws consider the quality of the state and its function as the basis for certain extra-contract privileges in relation to its contracts

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<sup>61</sup> Mitchell, *supra*, note 48.

<sup>62</sup> Turpin, *supra*, note 48 at 33.

<sup>63</sup> Art.1, s.10.ch.1.

<sup>64</sup> *Lochner v. New York*, 198 US (1905) 45, at 53.

<sup>65</sup> Epstein, *supra*, note 60 at 109.

<sup>66</sup> *Ibid.*

<sup>67</sup> Mitchell, *supra*, note 48 at 18.

<sup>68</sup> *Ibid.*

with private parties, including the power to unilaterally alter <sup>or</sup> terminate the contract. In relation to these prerogatives, it has been maintained:

The most radical of special prerogatives enjoyed by the administration is the right to terminate the contract unilaterally, when the public interest so requires. This drastic power is a widespread feature of national systems of procurement, and is evidently considered necessary in order to maintain the freedom of action of public authorities.<sup>69</sup>

Based on the presence of a conflict of private and public interest and the nature of the contract as an instrument of exercise of sovereignty, an analogy may be drawn between municipal law contracts of public authorities and foreign investment agreements. Thus, the presence of public interest in such contracts and the fact that one party is a state, which represents such interest, may be regarded as the basis for certain prerogatives of the state; namely, the power to modify or terminate the contract.

### 1.2.2.2 International Law

How does international law view contracts representing public and private interests? In principle, the main concern of international law is the relations between states. It is doubtful whether international law has a set of substantive rules concerning contracts between states and foreign nationals.<sup>70</sup> However, the relevance of international law to such contracts may be through the rules of states jurisdictional immunities and states responsibility for protection of aliens' property. The recent developments in both areas indicate that the sovereign quality of the state as a party to and the involvement of public interest in such contracts have been considered as grounds for the introduction of particular rules.

#### (i) States Immunity Rules

As will be seen in detail in chapter II, based on the fundamental principle of equality of states in international law, states are immune from jurisdiction of foreign courts.<sup>71</sup>

<sup>69</sup>Turpin, *supra*, note 48 at 40.

<sup>70</sup>See, Chapter IV, *infra*, 4.3.3.

<sup>71</sup>In general, see Schreuer, C., *State immunity: some recent developments*, Cambridge: Grotius Publications, 1988; also Brownlie, I., *Principles of Public International Law*, Oxford: Clarendon Press 1990, Ch. XV; Trooboff, P. D., *Foreign sovereign immunity: Emerging consensus of principles*, (1986) RCADI 245-429; Sinclair, L. I., *The law of sovereign immunity: recent developments*, (1980) 167 RCADI 113-284. Sornarajah, M., *Problems in Applying the Restrictive Theory of Sovereign Immunity*, (1982) 31 ICLQ 661.

This immunity traditionally was absolute i.e. there would be no jurisdiction for foreign courts over a sovereign state regardless of the commercial or public character of the underlying act.<sup>72</sup> This rule is the product of the time when state activities were normally limited to political acts. The increasing level of economic activities of state was followed by the adoption of the restrictive theory of sovereign immunity which denies immunity to the commercial activities of the state.<sup>73</sup> The issue here is whether the entry by the state into the market place would generally amount to its submission to the principle of equality of partners therein, or whether its sovereign quality continues to be a basis for the immunity privilege.<sup>74</sup> There have been arguments in favour of the total abandonment of sovereign immunity once a state has entered the market place.<sup>75</sup> According to international law, however, there are limits to the extent that state immunities can be taken away. As will be seen later in this work, the rule remains immunity and non-immunity is the exception.<sup>76</sup> It is only with regard to certain exceptions mainly the one relating to commercial activities of states (commercial activity exception) that the state loses its immunity. Thus state transactions may be immune or non-immune.

Here the difficult question of characterisation arises. It is difficult as there is no clear and generally-accepted concept of sovereign activities in international law, neither is there in different legal systems. Courts and legislation have largely focussed on the definition of the exception i.e. *acta jure gestionis* rather than the rule i.e. *acta jure imperii*. These definitions are often circular as they define the exception by reference to terms 'commercial' or 'sovereign authority'.<sup>77</sup>

<sup>72</sup> *The Porto Alexander case*, [1920] at 30 (UK); *Berizzi Bros. v. The Steamship Pesaro* 271 US 562 (1926).

<sup>73</sup> For a recent treatment of the doctrine of restrictive immunity and its history see the House of Lords in *Kuwait Airways Corporation v. Iraqi Airways Co.* [1995] 1 WLR 1147 at 1156-1160; also Schreuer, *ibid.*, esp. ch.2.

<sup>74</sup> The change from absolute immunity of state to a restrictive one has been considered as "a shift of emphasis [in international law] in favour of the equality of business partners of whom one is not a State." Passivirta, E., *Participation of States in International Contracts and Arbitral Settlement of Disputes*, Helsinki: Lakimiesliiton Kutannus 1990, 287. The question is how far this shift extends.

<sup>75</sup> See Schreuer, *supra*, note 71 at 7.

<sup>76</sup> See chapter II, *infra*, 2.5.4.

<sup>77</sup> The UK Sovereign Immunity Act for example defines a commercial transaction as a contract for the supply of goods or services, a financial transaction and "any other transaction or activity (whether of a commercial, industrial, financial, professional or other similar character) into which a state enters or in which it engages otherwise than in the exercise of sovereign authority."

Two different tests of 'nature' and 'purpose' have been employed to draw the line between commercial and non-commercial activities of states.<sup>78</sup> Application of either of the tests on its own has been criticised. The application of the purpose test has been rejected as it could result in the enlargement of the area of immune transactions to the extent of undermining the commercial activity exception.<sup>79</sup> The total reliance on the nature of the activity regardless of its purpose, followed by certain courts and some new codifications on the subject, has been also found unsatisfactory.<sup>80</sup> Despite the fact that, following a nature test, it is quite possible that many investment agreements are characterised as non-commercial<sup>81</sup>, the application of the nature test on its own has been objected to as being detrimental to the interests of developing countries.<sup>82</sup> It should be born in mind that many developing states find the application of the nature test of the restrictive theory of sovereign immunity detrimental to their development policies as they consider major projects relating to their development all as having public purpose and therefore being sovereign acts.<sup>83</sup> A case has been made for a 'nature and purpose test'; what is relevant here, Schreuer argues, is "how far we are prepared to look; how much of the purpose surrounding any particular activity we are prepared to accept as legally relevant."<sup>84</sup> The application of this test in particular has been advocated in the case of transactions involving developing states.<sup>85</sup> The

<sup>78</sup> Schreuer, *supra*, note 71 at 15.

<sup>79</sup> See *The Claim Against Empire of Iran, West German Constitutional Court*, 45 (1963) ILR 57.

<sup>80</sup> See Schreuer, *supra*, note 71 at 16.

<sup>81</sup> This is due to the fact that such agreements contain regulatory clauses which clearly distinguishes them from ordinary commercial agreements. In the field of exploitation of natural resources a certain degree of disagreement is seen between US and European cases. The European case law indicates that generally the immunity is not granted to the related activities in this field as far as they are carried out by a state entity rather than the state itself. In *Constitutional Complaints of the National Iranian Oil Company*, the German Federal Constitutional Court, agreed with the lower court which had rejected the argument that the banking account of the Company held in Germany were used for sovereign purposes i.e. to keep the profits of sales of oil on behalf of the Iranian Treasury. The Court held that the Company was an independent legal entity engaged in commercial activities and therefore was not entitled to immunity. See the translation in 22 (1983) ILM 1279. The US decisions, however, more readily consider such activities as *jure imperii*. See this in contrast with the decision of the US Court in *International Association of Machinists v OPEC*, (1981) 649 F.2d 1354, which considered the "price fixing policy" of the Organisation of Oil Exporting Countries (OPEC) as non-commercial and therefore an immune act; also Delaume, G., *Economic Development and Sovereign Immunity*, (1985) 79 AJIL 319.

<sup>82</sup> Sornarajah, *supra*, note 17 at 669.

<sup>83</sup> *Ibid.*

<sup>84</sup> Schreuer, *supra*, note 71 at 16.

<sup>85</sup> *Ibid.* at 17.

International Law Commission Drafts Articles have taken into account the concerns of such states by proposing a two-tier nature and purpose test. The Draft of Art.2(2) provides:

In determining whether a contract or transaction is a "commercial transaction" under paragraph 1(c), reference should be made primarily to the nature of the contract or transaction, but its purpose should also be taken into account if, *in the practice of the State which is a party to it, that purpose is relevant to determining the non-commercial character of the contract or transaction.*<sup>86</sup>

Consequently, if after the application of the "nature" test, the contract or transaction appears to be commercial, then it is open to the defendant State to contest this finding by reference to the purpose of the contract or transaction if in its practice, that purpose is relevant to determining the non-commercial character of the contract or transaction.<sup>87</sup>

Therefore, immunity is given a second chance.<sup>88</sup> On the adoption of this position the commentary to the Draft Articles states:

This two-pronged approach, which provides for the consideration not only of the nature, but in some instances also of the purpose of the contract or transaction, is designed to provide an adequate safeguard and protection for developing countries, especially in their endeavours to promote national economic development. Defendant States should be given an opportunity to prove that, in their practice, a given contract or transaction should be treated as non-commercial because its purpose is clearly public and supported by *raison d'Etat*, such as the procurement of food supplies to feed a population, relieve a famine situation or revitalise a vulnerable area, or supply medicaments to combat spreading epidemic, provided that it is the practice of that State to conclude such contracts or transactions for such public ends.<sup>89</sup>

A further point to mention here is related to the question whether it is the underlying contract or the act complained of which is relevant for the purposes of characterisation.

A valid nationalisation of a commercial contract rights may be amounted as *jure imperii* as the <sup>nature</sup> nature of the act of nationalisation and not that of contract is the relevant act. This position, which would expand the scope of sovereign acts, was taken by the court in *I Congreso del Partido* which formulated the test in the following:<sup>90</sup>

Under the "restrictive" theory the court has first to characterise the activity into which the defendant state has entered. Having done this, and (assumedly) found it to be a commercial, or private law, character, it may take the view that contractual breaches, or torts, prima facie fall within the same sphere of activity. It should then be for the defendant state to make a case that the act complained of is outside that sphere, and within that of sovereign action.

<sup>86</sup> 1992 Draft Articles on Jurisdictional Immunities of States and Their Property (transcript), Commentary at 3.

<sup>87</sup> The explanatory note to the draft Article 2, *ibid.* at 30.

<sup>88</sup> *Ibid.*

<sup>89</sup> *Ibid.*

<sup>90</sup> 64 ILR 307, [1983] 1 AC 244 (H.L.).

The public law aspect of states' activities and the overall objective of protection of public interests involved therein have had some influence on national laws with regards to the questions of arbitration agreement as an exception to immunity and the immunity of states and their property from measures of execution.<sup>91</sup> With regard to both matters, the sovereign quality of the state and the public interest element of the underlying activity have been regarded as the basis for special rules thereon. In principle, since an arbitration agreement represents the consent of the state party to jurisdiction of an arbitral tribunal it should be considered as an exception to immunity separate from the commercial activity exception. However, a number of legislations and also the ILC Draft Articles limit the effect of arbitration agreement to immunities of states in relation to commercial matters.<sup>92</sup> Therefore, in jurisdictions following this approach, the enforceability of an arbitration clause would depend on the characterisation of the underlying transaction or the act complained of as commercial.<sup>93</sup> Furthermore, as will be noted in chapter VI, in the light of interstate considerations, the immunity of state property in general, and characterisation of such property as commercial in particular, are covered by stricter rules. In the view of diplomatic privileges and other interstate considerations, the characterisation of the object against which measures of enforcement are sought is normally based on the purpose that such an object is used for rather than its nature.<sup>94</sup>

To sum up, in the context of immunity rules, international law has continued to recognise the inequality of parties to contracts involving public interests. The fact of the entry by the state into the market place, has resulted in the introduction of a doctrine of restrictive immunity according to which states do not enjoy immunity with regard to their commercial acts. This however has not essentially affected the applicability of immunity to the public acts of state as according to the restrictive theory states still enjoy the immunity privilege as a rule. The commercial activity clause remains the exception which is reserved only for situations where the character of the

<sup>91</sup> In relation to arbitration agreement as a waiver of sovereign immunity see chapter II, *infra*, 2.5.4; For the study of immunity of states and their property against measures of execution see ch.VI, *infra*, 6.2.3.

<sup>92</sup> For example, according to Art. 12 (1) of the European Convention on State Immunity the scope of the arbitration agreement as a waiver extends only to civil and commercial matters.

<sup>93</sup> See Scheruer, *supra*, note 71.

<sup>94</sup> *Ibid.* at 62; This point is dealt with in detail in chapter VI below.

underlying transaction or the act complained of is clearly commercial. i.e. where both states and the private party follow interests of a private nature in relation to the activity in question. The fact that, for the purpose of characterisation, the purpose of the activity may be taken into account, is a further recognition by international law of the sovereign quality of the state party and the involvement of public interest as a ground for the state's immunity privilege.

(ii) *State Responsibility for Protection of Aliens Property and Nationalisation*

Another area of international law where the sovereign quality of the state is considered as a ground for certain privileges is the one related to the taking of foreign property. Under international law, similar to national law concerning taking of property by the state, the requirement of public interest may be considered as a ground for the state's power to take foreign private property.<sup>95</sup> In principle, based on its recognition of property rights, international law imposes an obligation on states to protect the property rights of aliens situated in their territory.<sup>96</sup> This obligation is owed to the home state of the alien. This rule, which is ultimately geared to the protection of private interest of aliens, is not absolute (the question of the challenges to the rule and the controversy over the standard of protection are not considered here). In order to exercise control over the economy, or sectors thereof, states in socialist and developing as well as western countries have embarked upon nationalisation programmes. According to customary international law, a state may in principle take the property of a foreign private person within its own jurisdiction, provided that it does so for a *public purpose* and in the absence of discrimination; and provided that compensation is paid.<sup>97</sup>

<sup>95</sup>The 1962 General Assembly Resolution 1803(XVII) provides: "Nationalisation, expropriation or requisitioning shall be based on grounds or reasons of public utility, security or the national interest which are recognised as overriding purely individual or private interests, both domestic and foreign. In such cases the owner shall be paid appropriate compensation, in accordance with the rules in force in the State taking such measures in the exercise of its sovereignty and in accordance with international law. In any case where the question of compensation gives rise to a controversy, the national jurisdiction of the State taking such measures shall be exhausted. However, upon agreement by sovereign States and other parties concerned, settlement of the dispute should be made through arbitration or international adjudication."; also Brownlie, *supra*, note 71 at 531-545.

<sup>96</sup>In general see Borchard, *supra*, note 7.

<sup>97</sup>Higgins, R., *The Taking of Property by the State: Recent Development in International Law*, (1982) 176 RCADI 259 at 298; Brownlie, *supra*, note 71 at 531-545.

(iii) *Recent Arbitral Practice*

The study of recent arbitral awards points to a recognition by many arbitral tribunals of the public law aspect of the contract as a basis for the state party's special privileges.<sup>98</sup>

The tribunal in *Aminoil* confirmed the recognition by international law of the position of the state party as the "supreme protector of general interest."<sup>99</sup> This position was also emphasised in relation to the non-applicability of certain stabilisation clauses against the right of the state to nationalise private property rights under an investment agreement of long-term duration.<sup>100</sup> With regard to the application of the principle of *pacta sunt servanda* which had been contended by the Company the tribunal noted that:

This concession - in its origin is a mining concession granted by a State whose institutions were still incomplete and directed to narrow patrimonial ends- became *one of the essential instruments in the economic and social progress of a national community in full process of development*. This transformation, progressively achieved, took place at first by means of successive increases in the financial levies going to the State, and then through the growing influence of the State in the economic and technical management of the undertaking, particularly as to the control of pricing policy, taken over in 1973, and the regulation of works and investment programmes. *The contract of concession thus changed its character and became one of those contracts in regard to which, in most legal systems, the State, while remaining bound to respect the contractual equilibrium, enjoys especial advantages* (italics supplied).<sup>101</sup>

The Tribunal in *Amoco Finance* noted: "in no system of law are private interests permitted to prevail over duly established public interests, making impossible actions

<sup>98</sup> There is the view advocated, among others, by Professor Dupuy in *Texaco* which, in the light of presence of certain contractual terms, considers state contracts as "internationalised" i.e. subject to international law. According to this view, international law principle of *pacta sunt servanda* is applicable to such contracts and therefore, they are treated as contracts between equals; state sovereignty and public interest give way to primacy of private interest. 53 ILR 389 at 462. The existence and viability of international law contracts as expressed by the award, as will be elaborated in other parts of this work, have been strongly criticised. See Chapter IV, infra, 4.3.3; Bowett, *State Contracts with Aliens: Contemporary Developments on Compensation for Termination or Breach*, (1988) LIX BYIL 49 at 59.

<sup>99</sup> *Aminoil Award*, (1982) 21 ILM 976 at 1001.

<sup>100</sup> No doubt contractual limitations on the State's right to nationalise are juridically possible, but what that would involve would be a particularly serious undertaking which would have to be expressly stipulated for, and be within the regulations governing the conclusion of State contracts; and it is to be expected that it should cover only a relatively limited period. In the present case however, the existence of such a stipulation would have to be presumed as being covered by the general language of the stabilisation clauses, and over the whole period on an especially long term concession since it extended to 60 years. A limitation on the sovereign rights of the State is all the less to be presumed where the concessionaire is in any event in possession of important guarantees regarding its essential interests in the shape of a legal right to eventual compensation. *Ibid.* at 1023.

<sup>101</sup> *Ibid.* at 1023-4.

required for the public good".<sup>102</sup> Similarly, the Tribunal in the *Amco* case, in the light of the type of agreement in question and the terms therein, stated: "However, it [the relationship established between Amco Asia and Indonesia] is not identical to a private law contract, due to the fact that the State is entitled to withdraw the approval it granted for reasons which could not be invoked by a private contracting entity, and/or to decide and implement the withdrawal by utilising procedures which are different from those which can and have to be utilised by a private entity."<sup>103</sup> In *SPP v. Egypt*, the ICSID tribunal took the view that a cancellation by the State of an agreement concerning a tourist development project as "a lawful exercise of the right of eminent domain".<sup>104</sup>

In short, state contracts, as legal instruments representing transactions between states and private parties in a transnational setting, are largely phenomena of our time. They contain a conflict between public and private interests. From the point of view of the state party, the contract acts as an instrument of economic policy which is reflected in the new forms of contracts including clauses providing for certain regulatory powers and also in the overall object of the contract. While the interest of the private party normally requires a stable contract regime, the dual function of the state party requires a more flexible regime which can appropriately respond to the changing demands of public interest. Both municipal and international laws, have taken into account the needs of this rather new role of the state by providing regimes which aim to accommodate the public interest element.

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<sup>102</sup> *Amoco International Finance Corporation v. Islamic Republic of Iran* (1987) 15 Iran-US CTR 189 at 242-3.

<sup>103</sup> *Amco Asia Corp. et al. v. The Republic of Indonesia* (Merits), Award of November 21, 1984 (1985) 24 ILM 1022 at 1029.

<sup>104</sup> *Southern Pacific Properties (Middle East) v. Arab Republic of Egypt*, Award of 192, reprinted in (1993) ICSID Rev.-FILJ 328 at 373. Indeed, the inequality of the parties and the protection of the public interest aspect of state economic activities, in particular those involving developing countries, have been emphasised as the objective of new branches of international law. The recognition of the special position of the State as a party to state contracts in the international arena has made some commentators consider the existence and development of international administrative contracts which have the "situation of the contracting state... at the centre of any inquiry." Kahn, P., *The Law of Development and Arbitration Tribunals*, In *International Law of Development: Comparative Perspective*, Edited by F.Snyder and P. Slinn, 1987, 1163 at 173. See also Fatouros, A., *Government Guarantees to Foreign Investors*, New York/London: Columbia University Press 1962, 208. Furthermore, the inequality of the parties to long-term investment agreements between developing states and private investors has been the basis of an argument for a newly emerging customary international law, the international law of development, which addresses, among other things, certain questions relating to state contracts. See Slinn, P., *Differing Approaches to the Relationship Between International Law and Development*, in *International Law of Development: Comparative Perspective*, 27 at 29.

Since, as noted above, the characterisation of the state activities depends on factors which may change from one type of state contracts to another, or indeed from one contract to another, it is extremely difficult to give a comprehensive definition of state contracts. Such difficulties in giving an all encompassing definition of state contracts have made some commentators characterise state contracts by examining the role of public interest in various types of contracts that a state may enter into with a foreign private party.<sup>105</sup> In this context, certain contracts have been generally argued to fall within the ambit of state contracts proper such as agreements in the natural resources sector and those generally involving the development plans of states. For instance it has been maintained that "[T]he transformation of the old concession agreement in the natural resources sector into new types of agreements illustrates how contractual structures designed to promote the commercial interests of foreign parties were gradually changed to reflect the dominance of public interest elements."<sup>106</sup>

### 1.2.3 State Enterprises

It remains to be said that in addition to the direct participation, the State's involvement in international economic activities may be through their instrumentalities with or without separate legal personality. State enterprises have become major participants in this field. Western market-economy countries as well as socialist

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<sup>105</sup> Professor Audit, in his work on arbitration and state contracts, has distinguished three categories of state contracts. First, those contracts in relation to which the private party recognises the predominance of the public interest and voluntarily places himself under the public law regime of the contract, consents to the application of the law of the state party and to the jurisdiction of its courts. Examples of this kind are administrative contracts in countries where they are recognised by law as a distinct category such as *contrats administratifs* in France. Such contracts do not usually contain an arbitration clause. The second category pertains to contracts which are normal private contracts where the state acts as a private person and the contract is subject to private law, and the public regulatory power of state has no role to play. An example of this kind is a spot purchase of commodities by a state. In the third category, state contract proper, the parties follow distinct interests. On the one the one hand, the state party acts in the interest of the public and, in so doing, tries to bring the contract under a public law regime which makes allowances for measures taken in the pursuit of the promotion and the protection of the public interest. On the other hand, the private party seeking profit maximisation, tries to bring the contract under a regime of private law which is based on the absolute sanctity of contract. Audit, B., *Transnational Arbitration and State Contracts: Finding and Prospects*, Kluwer 1988, 84-7.

<sup>106</sup>Sornarajah, *International Commercial Arbitration: Problem of State Contracts*, Singapore: Longman 1990, 75.

countries set up such entities as means of enforcing their economic policies.<sup>107</sup> In the Third World, major projects are often undertaken by state enterprises. This is based on policy grounds and is also due to the relatively small size of the private sector which renders it incapable of embarking on large-scale projects. The recent politico-economic changes in Eastern Europe and elsewhere involve a shift from state-controlled to free-market economies. In the process, a large number of state enterprises are being privatised. However, state enterprises still play an important role especially in developing countries in areas such as exploitation of natural resources and air and sea transport.<sup>108</sup> In principle, state enterprises, with regards to contracts of a public nature, enjoy the same privileges as the state. This is recognised in municipal laws on government contracts and international law on state immunities.<sup>109</sup>

<sup>107</sup> For a general study of different kinds of enterprises in the various economic systems see Madl, F. (ed.) *Enterprise Collection: First international civil law conference*, Budapest: Budapest University 1985; enterprises in mixed economies see Friedmann, W., *Public and Private Enterprise in mixed Economies*. London: Stevens 1974. Also Mann, F.A., State corporations in international relations, in *Liber Amicorum for Lord Wilberforce*, Edited by Bos, M. and I. Brownlie, Oxford: Clarendon Press 1987, 131; Hohenveldern, I., *Corporation in and under international law*, Cambridge: Grotius 1987.

<sup>108</sup> See Baumol, W., *Public and Private Enterprise in a Mixed Economy: Proceedings of a Conference held by the International Economic Association in Mexico City*, edited book, London and Basingstoke: The Macmillan Press Ltd. 1980, esp. Part One; State enterprises also play an important role in the developed industrial world. A recent study shows that 10-15 percent of turn over and employment in the Norwegian industry including mining is represented by the state-owned enterprises. *OECD Review of Foreign Direct Investment: Norway*, Paris: OECD Publications 1995 at 33-34.

<sup>109</sup> As regards the characterisation of such contracts, the question, within the relevant legal orders, has been addressed by reference to either their legal status or the function performed by such entities. In France for example the question is decided according to the function performed by the entity in that to the extent that the entity concerned is involved in matters of public service and possesses the prerogatives of the public authority from which it originates, it might be subject to public law. Drago, In Friedmann, *ibid.* at 10-11. In the context of state immunities rules, under the absolute rule, the main criterion is the status of the enterprise in that factors such as incorporation legal personality, capacity to hold property, capacity to sue and be sued and government control were taken into account. See in general Scheruer, *supra*, note 71. The function of the enterprise would be looked at only as a secondary step in the context of determining the object of enterprise in general and not specifically in relation to the particular transaction. The trend in favour of the restrictive immunity has given rise to a shift, manifested in national legislation, in favour of the functional approach i.e. the criterion for characterisation of whether the act could be performed by a private person. France takes a more restrictive view in its interpretation of the commercial activity exception as it takes the purpose of the act as the basis of the characterisation. Therefore, a state's buying of cigarette for the army has been considered immune by a French court. See Hohenveldern, *ibid.* at 62 and the case *Gugeheim v. Etat du Vietnam* cited therein. Thus a state entity without a separate legal personality may be denied immunity from jurisdiction of a foreign court in an action arising out of a commercial contract. Conversely, a transaction entered into by commercial entity of a state is considered as being immune when it relates to the exercise of a governmental function. Scheruer, *supra*, note 71 at 92-101.

### 1.3 International Commercial Arbitration

Arbitration<sup>110</sup> has been defined in a broad sense as "a device whereby the settlement of a question, which is of interest for two or more other persons, is entrusted to one or more other persons."<sup>111</sup> Originally, arbitration was a simple method of resolving disputes. After creation of State courts and judiciary, arbitration served as a method of dispute settlement which involved less formality and expense than court litigation.<sup>112</sup> In principle, international commercial arbitration, as a private method of dispute settlement, operates in the framework of national laws.<sup>113</sup> There are a number of links between national laws and international commercial arbitration including the supervisory role that national courts play, the assistance given by such courts to arbitration during the proceedings and also the recognition and enforcement of arbitral awards by national courts.<sup>114</sup> There is, however, a movement to detach many of the existing links between such arbitration and national laws and with that to create an almost purely private and independent dispute settlement system.<sup>115</sup> This is to some extent in conformity with the desire of national legislatures in promoting their country as a popular *situs* for the lucrative business of commercial arbitration and also in reducing the workload of their courts.<sup>116</sup>

<sup>110</sup> This is different from public international arbitration: "International arbitration has for its object the settlement of differences between States by judges of their own choice, and on the basis of respect for law." Art.15 of the the Hague Convention of 1899 which providing for the establishment of the Permanent Court of Arbitration. For the text of the Convention see Wetter, G., *International Arbitral Process*, Dobbs Ferry, New York 1979, vol.5 at 201.

<sup>111</sup> David, R., *Arbitration in International Trade*, Kluwer 1985 at 5.

<sup>112</sup> Holdworth, *History of English Law*, 1964, vol.xiv, 187.

<sup>113</sup> Redfern and Hunter, *Law and Practice of International Commercial Arbitration*, 2nd ed., London: Sweet and Maxwell 1991, 81.

<sup>114</sup> For example, according to Arts. 11(3), 11(4), 13(3), 14, 16(3) and 34 (2) of the UNCITRAL Model Law, courts of the place of arbitration have competence to assist and supervise arbitration. The provisions of the New York Convention are enforced through the intervention of the courts of the country where recognition and enforcement of the arbitral award is sought.

<sup>115</sup> Paulsson, J., *Delocalisation of international commercial arbitration: when and why it matters*, (1983) 32 ICLQ 53. The theory of delocalisation of arbitration is discussed in detail in Ch. III, *infra*, 3.3.2.2.

<sup>116</sup> The changes to English law on arbitration by the 1979 Act were mainly influenced by the desire of the legislator to attract more arbitration business to England. Following this aim, as will be seen in Ch.III, parties were given the right to exclude, to a great extent, the supervisory role of English courts. These rules, however, are not applicable to arbitration of disputes relating to shipping, insurance and commodities contracts as England had already established an almost monopoly in these area.

### 1.3.1 Legal Nature of Arbitration

On the legal nature of arbitration three major schools of thought are to be distinguished.<sup>117</sup> According to the traditional view, that is the jurisdictional theory, arbitration is of a juridical character and therefore subject to the control of the law and courts of the seat of arbitration.<sup>118</sup> It is that law which gives effect to the agreement of the parties, power of the arbitrator and enforceability of the award. Courts of the place of arbitration have a supervisory role in the proper conduct of arbitral proceedings. The most important elements in determining the attitude of the parties towards arbitration are argued to be correctness, predictability and certainty.<sup>119</sup> These are secured only when the arbitration is subject to the supervision of the courts. In the absence of such supervision, and given the immunity of the arbitrator and unreviewability of arbitral awards, there could be situations where a fundamentally wrong decision of an arbitrator could gain legally binding force unchallenged.<sup>120</sup>

While recognising the principle of party autonomy, the jurisdictional theory considers national law as the source of that principle and its limits. It is only due to the permission of national law that parties may design their dispute settlement method, its procedure and rules according to which the dispute is decided.<sup>121</sup> The source of the power of the arbitrator is national law and not the agreement of the parties *per se*. It is for this similarity between the arbitrator and a state judge that their decisions i.e. arbitral awards and court judgments should be treated in the same way, and therefore an arbitral award is not self-executing and the award-winning party should apply to the local courts in the same way as with a court judgment.<sup>122</sup>

The contractualist theory, on the other hand, is based on party autonomy; the legal

<sup>117</sup>Lew distinguishes four theories on the nature of arbitration. The fourth one being the autonomous theory of arbitration "the nature of which should not be defined by reference to the contract or to the jurisdiction, but whose legal authority is to be justified both by its purpose and by the guarantees necessary for those parties who do not bring their disputes before the official courts" Madame Rubellin Devichi as quoted in Lew, J., *Applicable Law in International Commercial Arbitration: A Study in Commercial Arbitration Awards*, Dobbs Ferry 1978, 59.

<sup>118</sup> See, Ch.III, *infra*, 3.3.1.; also Redfern and Hunter, *supra*, note 113 at 88-93.

<sup>119</sup> Mann, F.A., *Private Arbitration and Public Policy*, (1985) 4 *Civil Justice Quarterly* 257 at 259.

<sup>120</sup> Kerr, L. J., *Arbitration and the Courts*, the UNCITRAL Model Law, (1985) 34 *ICLQ* 1 at 14.

<sup>121</sup> Jarvin, S., *The sources and limits of the arbitrator's powers*, In *Contemporary Problems in International Arbitration*, edited by J. Lew, London: Kluwer 1986 at 50.

<sup>122</sup> Lew, *Applicable Law, Supra*, note 117 at 53.

basis of an arbitration is the agreement of the parties and it is that agreement which is the source of the arbitrator's power.<sup>123</sup> Parties are free to choose or design rules of procedure and substance, or authorise the arbitrator to do it for them. The award is enforced by courts as a contract. Therefore, there would be no room for any courts' power of supervision and intervention in the arbitral proceedings.<sup>124</sup> This theory is regarded as best suited to the interests of the international business community as it sees arbitration as an "instrument of free enterprise" capable where necessary of responding to the specific requirements of the community of merchants.<sup>125</sup> It has however been criticised on the ground that parties' will cannot play a primary role in creating legally binding results. There should be definite provisions of a legal system on which parties' will rely.<sup>126</sup>

To avoid criticisms directed against the above theories, a third theory, the hybrid or mixed nature theory, has been advanced.<sup>127</sup> While arbitration could not be beyond every legal system, it could not realistically be denied that an arbitration has its origin in the parties' will.<sup>128</sup> The agreement of the parties is a contract between them, whereas as regards proceedings it is subject to the procedural law of the seat of arbitration.<sup>129</sup> The advantage of this theory is that while it recognises the contractual aspects of arbitration, it does not antagonise national courts, and therefore, maintains the necessary relationship between the courts of the seat of arbitration and arbitral tribunals. As a result, party autonomy is respected as far as it is recognised by the law of the seat i.e. the scope of parties' freedom, or that of the arbitrator in the absence of their choice, to design rules of procedure is defined by the law of the place of arbitration. This theory presents a more realistic view of contemporary arbitration whereby, according to the New York Convention, there remains some scope for the

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<sup>123</sup> De Vries, H. P., International commercial arbitration: substitute for national courts, (1982) 57 Tulane Law Review 42; David, *supra*, note 111 at 5.

<sup>124</sup> Lew, *Applicable Law*, *supra*, note 117 at 56.

<sup>125</sup> *Ibid* at 57.

<sup>126</sup> Szaszy, Recognition and Enforcement of Foreign Arbitral Awards, (1966) 60 AJIL at 667.

<sup>127</sup> *Ibid*, at 669-71; Lew, *Applicable Law*, *supra*, note 117 at 57-59; Redfern and Hunter, *supra*, note 113 at 129.

<sup>128</sup> Redfern and Hunter, *ibid*.

<sup>129</sup> Lew, *Applicable Law*, *supra*, note 117 at 58; Szaszy, *supra*, note 126 at 670.

public policy limitations of national law.<sup>130</sup>

### 1.3.2 Delocalisation or Privatisation of International Commercial Arbitration

An argument has been advanced in the field of international commercial arbitration for the delocalisation of the procedure of arbitration through the introduction of a totally private system of administration of justice detached from the control of any national legal system.<sup>131</sup> In essence, what the advocates of this kind of arbitration would like to achieve is the elimination of the supervisory role of national laws on arbitration - a system of arbitration free from external control.<sup>132</sup> Party autonomy is the cornerstone of this view. Arbitration and the award are seen as purely contractual in nature.<sup>133</sup> Thus, they should be immune from the application of the peculiarities of national laws not intended by the parties. More particularly, any recourse to courts would be seen as "a deviation from the process agreed to by the parties."<sup>134</sup>

The theory of delocalisation is based on the contractual theory of arbitration.<sup>135</sup> Within the framework of a delocalised arbitration, the arbitral tribunal would ideally have the final word on its jurisdiction. Furthermore, arbitration would be conducted according to the rules agreed on by the parties. Failing a determination by the parties, the arbitral tribunal would have the power to choose or design such rules of procedure which it considers appropriate. As a result of this detachment of arbitration from national laws, including those of its seat, there would not be any room for the mandatory application of the conflict-of-laws rules. This leads to greater powers for the arbitral tribunal in determining the applicable standards according to which the decision on the merits of the case is made. Failing a choice of the applicable

<sup>130</sup> New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958, United Nations Treaty Series (1959) Vol. 330, 38, reproduced in Wetter, *International Arbitral Process*, New York: Dobbs Ferry 1979, 308. By July 1994, 97 countries had acceded the Convention. For a list of those countries see the Scoreboard produced in (1994) 9 *New and Notes from the Institute for Transnational Arbitration*, no.3.

<sup>131</sup> Paulsson, J., *Delocalisation of international commercial arbitration: When and why it matters*, (1983) 32 *ICLQ* 53; Paulsson, J., *Arbitration unbound: award detached from the law of its country of origin*, (1981) 30 *ICLQ* 358.

<sup>132</sup> See Redfern and Hunter, *supra*, note 113 at 129.

<sup>133</sup> See, *supra*, 5.

<sup>134</sup> Craig, W. L., *Uses and Abuses of Appeal*, (1988) 4 *Journal of International Arbitration*, 181.

<sup>135</sup> See Chapter III, *infra*, 100.

substantive law by the parties, the arbitral tribunal would have the power to determine the applicable legal or non-legal standards upon which the determinations on the substance of the dispute are made.<sup>136</sup>

To neutralise the limiting effects of national public policy on arbitration, some proponents of the “delocalisation” theory have advanced the theory of transnational public policy, a kind of public policy based on the communality of principles of national public policies yet totally separate from any particular national system.<sup>137</sup> Such “transnational” or “truly international” public policy is distinguished from the international public policy of a state - that part of national public policy which applies to cases involving an international element. Rules of such transnational public policy would be defined by international arbitral tribunals and not by national laws.<sup>138</sup>

Therefore, in this kind of procedurally delocalised arbitration the conduct of proceedings and other matters would be tested against standards defined by arbitral tribunals at a “transnational level.” More specifically, the question of arbitrability which is of a public policy nature, would be taken away from the reach of national laws and would be decided by arbitral tribunals.<sup>139</sup>

In an entirely delocalised arbitration, it would be possible for arbitral tribunals to apply non-municipal standards to the substance of the dispute. In this context, a case is made for the application of the *lex mercatoria* as the source of rules best suited to the needs of international commerce.<sup>140</sup> More particularly, the applicability of the *lex mercatoria* is proposed to cases involving state contracts.<sup>141</sup>

The outcome of a procedurally delocalised arbitration would be an “anational” or

<sup>136</sup> The discussion of delocalisation of substantive law, chapter IV, *infra*, 144.

<sup>137</sup> Lalive, P., Transnational (or truly international) public policy and international commercial arbitration, In *Comparative arbitration practice and public policy in arbitration*, Edited by P. Sanders, Kluwer 1987, 312.

<sup>138</sup> See Chapter II, *infra*, 57.

<sup>139</sup> *Ibid.*

<sup>140</sup> See generally Goldman, B., The applicable law: general principles of law- the *lex mercatoria*, In *The Contemporary Problems in International Commercial Arbitration*, Edited by J. Lew, London: 1986; Lando, O., The *lex mercatoria* in international commercial arbitration, (1985) 34 ICLQ 747-768; Mustil, R., The New *lex Mercatoria*: The First Twenty-Five Years, In *Liber Amicorum for the Rt. Hon. Lord Wilberforce*, Edited by M. Bos and I. Brownlie, Oxford: Clarendon Press 1987, 149; Carbonneau, T., *lex mercatoria and arbitration*, New York: Transnational Publishers, Inc.: Transnational Juris Publications 1990.

<sup>141</sup> See Carbonneau, T. E., The Remaking of Arbitration: Design and Destiny, In *Lex Mercatoria and Arbitration*, *ibid.*, 1 at 8 (footnotes omitted).

“delocalised” award - an award without nationality.<sup>142</sup> The proponents of totally detached arbitration have long advocated a regime of enforcement of “delocalised” awards.<sup>143</sup> They argue that the prevailing regimes of recognition and enforcement, which mainly focus on awards which have a nationality other than that of the place of enforcement i.e. foreign awards, may also cover delocalised awards.<sup>144</sup> The ultimate form of a procedurally delocalised arbitration is a kind of purely private system of dispute resolution free from any form of state control.

As mentioned above, in a delocalised arbitration, the arbitral tribunal will have more freedom to apply such non-municipal standards as the “common law of international arbitration”, the general principles of international trade law or the *lex mercatoria*.<sup>145</sup> Previous arbitral awards and legal writings may be extensively relied on by the arbitral tribunal as a source of substantive rules. It is common practice for the parties to arbitration proceedings in supporting their cases and also for arbitral tribunals in justifying their awards to rely on the awards of other arbitral tribunals as a guiding source.<sup>146</sup> Samuel observes that “with more and more arbitral tribunals forsaking municipal laws (both private international and substantive), awards are increasingly becoming the sole source of judicial material on issues arising in certain international cases.”<sup>147</sup> Such a situation is especially likely to occur in cases where the tribunal moves away from the application of legal standards and tends to rely more heavily on a relatively small number of awards.

### 1.3.3 International Business Community and Int. Commercial Arbitration

Today, international commercial arbitration has gained much popularity amongst the members of the international business community as it conforms to their various

<sup>142</sup> For the definition of ‘anational’ or ‘delocalised’ awards see Ch.III, *infra*, 3.3.2.2.

<sup>143</sup> Indeed, the original draft of what became the New York Convention presented by the ICC was to introduce a regime of recognition and enforcement of “international” awards i.e. awards made following a delocalised procedure as opposed to “foreign” awards which are made under the procedural law of a country other than that of the place of arbitration.

<sup>144</sup> See chapter VI, *infra*, 6.2.1.

<sup>145</sup> For a discussion of this law see Lalive, Transnational (or truly international) public policy, *supra*, note 137 at 295-6.

<sup>146</sup> See a general discussion of the precedent in Berger, K. P., The International Arbitrators' Application of Precedents, (1992) 9 Journal of International Arbitration 5.

<sup>147</sup> A. Samuel, A., Book Review in (1992) LMCLQ, 128.

interests; in particular neutrality, finality, speed, confidentiality and informality.<sup>148</sup> A major factor in choosing to go to arbitration is a psychological one. A party to an international business dispute is usually reluctant to appear before a foreign court, especially if the foreign court has the nationality of the other party. By referring the dispute to arbitration, not only will this problem be avoided, but the level of the parties' trust in the chosen arbitrator will further enhance the likelihood of compliance with the award.

The 'finality' of the process is a major ground for the popularity of arbitration among the members of the international business community since it results in the speedy resolution of the disputes.<sup>149</sup> The decision of an arbitral tribunal on the substance of the dispute ( i.e. "the award") is normally final and, except for the limited right of recourse provided by national laws, there is not normally the broad right of appeal against an arbitral award.<sup>150</sup> As will be shown below, the countries most-often chosen as the seat of arbitration increasingly adopt less or non-interventionist policies towards international commercial arbitration, allowing for a minimum of control over arbitration and hence enhancing the element of 'finality' of the process.<sup>151</sup>

The 'confidentiality', or rather the private nature, of the process allows the parties to have their disputes adjudicated without having to be subjected to the publicity normally surrounding court proceedings, which could harm their business reputation and

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<sup>148</sup> Redfern and Hunter, *supra*, note 113 at 23.

<sup>149</sup> Indeed, as will be seen in Ch. III, in order to attract more arbitration business, the main incentive given by national legislation on arbitration to the international business community has been the reduction or exclusion of judicial control over arbitration.

<sup>150</sup> In countries with legislation on arbitration, the tendency is to limit the grounds of setting aside awards to those of refusal of recognition and enforcement. Compare, for example, the provisions of Art. 34(2) of UNCITRAL Model Law with Art. V of the New York Convention.

<sup>151</sup> See chapter III, *infra*, 3.3.2.

creditworthiness in the market.<sup>152</sup>

The 'informality' feature of arbitration allows the arbitral tribunal to conduct the proceedings in a way which conforms to the procedural expectations of the parties, who often come from different legal backgrounds.<sup>153</sup> For example, with respect to procedural aspects such as rules concerning evidence there may be considerable differences between the parties' respective legal systems.<sup>154</sup> In an international commercial arbitration it may be possible to have a procedure based on a combination of the features of various legal systems such as those of the civil and the common law.<sup>155</sup>

Furthermore, a network of bilateral and multilateral treaties ensure, to a large extent, that arbitral awards will be granted recognition and enforcement in most parts of the world. In this context, the 1958 United Nations Convention on Recognition and Enforcement of Foreign Awards<sup>156</sup>, better known as the New York Convention, adopted by a great number of states, has provided a simple and effective enforcement

<sup>152</sup> It is to be noted, however, that the degree of the confidentiality of the procedure of arbitration and the award depends on the relevant applicable laws. For instance an English Court held that there is an implied term in every arbitration agreement which imposes a duty of confidence on the arbitrating parties and the arbitrator preventing them from disclosing documents presented in the course of proceedings and the award. *Hassneh Insee v. Mew* [1993] 2 LLR 243. The court further noted that "[I]t [the duty of confidence] is not a question of immunity or public interest. It is a question of an implied obligation arising out of the nature of arbitration itself." (446) There are however exceptions to this rule. For example, an award should be disclosed to a third party when it is to "found a defence or as the basis for a cause of action, so to disclose it would not be a breach of the duty of confidence." (249) By contrast, In *Esso Australia Resources et al. v. The Minister for Energy et al.*, High Court of Australia, March 1994 and April 1995, the Court in a majority ruling took an opposite view. Chief Justice Mason expressing the view of the majority in the case stated: "[D]espite the view taken in *Dolling-Barker* and subsequently by Colman J in *Hassneh Insurance*, I do not consider that, in Australia, having regard to the various matters to which I have referred, we are justified in concluding that confidentiality is an essential attribute to a private arbitration imposing an obligation on each party not to disclose the proceedings or documents and information provided in and for the purposes of arbitration" (Mason C.F.: para.35). "It follows that the case for an implied term must be rejected for the very reasons I have given for rejecting the view that confidentiality is an essential characteristic of a private arbitration"(para.37).

<sup>153</sup> Paulsson, J., Cross-enrichment of Public and Private Law dispute Resolution Mechanisms in the International Arena, (1992) 9 *Journal of International Arbitration* 59 at 66.

<sup>154</sup> There are fundamental differences in laws of procedure between civil and common law countries. The former countries follow inquisitorial procedure whereas the latter are adherents of adversarial procedure. Smit, H., *Substance and Procedure in International Arbitration: The Development of a New Legal Order*, (1991) 65 *Tulane Law Review* 1309.

<sup>155</sup> Paulsson, *supra*, note 153 at 62-64.

<sup>156</sup> United Nations Treaty Series (1959) Vol.330, p.38, No.4739 reprinted in Redfern and Hunter. *supra*, note 81 at 712.

mechanism.<sup>157</sup>

The large number of commercial disputes referred to arbitration<sup>158</sup> the increasing number of private arbitration institutions<sup>159</sup> and the adoption of new rules<sup>160</sup> and legislation<sup>161</sup> on international commercial arbitration all support the claim of the popularity of this method of dispute settlement among the members of the international business community.<sup>162</sup> The International Chamber of Commerce, for example, offers extensive facilities for arbitration of international business disputes. It adopted its first rules of arbitration in 1922, and its Court of Arbitration was established in 1923.<sup>163</sup> The policy objectives of the ICC include the globalisation of trade. In pursuit of this, further reduction and elimination of role of the state as regulators of international trade would be seen as major steps forward.<sup>164</sup> Indeed the ICC was founded to challenge, through the internationalisation of trade and its regulation, protectionist policies of national states, which were viewed as among the main causes of war. The first draft of

<sup>157</sup> General commentary see Van den Berg, A., *The New York Convention of 1958: Towards a Uniform Judicial Interpretation*, The Hague: T.M.C. Asser Institute 1981.

<sup>158</sup> For example, between 1923 and 1988, a total of 6000 cases were filed with the ICC Court of Arbitration. Craig, W. L., W. W. Park and J. Paulsson, *International Chamber of Commerce Arbitration*, New York: Oceana Publications, Inc. ICC Publishing S.A. 1990 at 4.

<sup>159</sup> Amongst the most popular ones are the ICC Court of Arbitration, London Court of International Arbitration (LCIA), American Arbitration Association (AAA) and Stockholm Chamber of Commerce Arbitration.

<sup>160</sup> E.g. Arbitration Rules of American Arbitration Association, reprinted in Redfern and Hunter, *supra*, note 113 at 541.

<sup>161</sup> E.g. new legislations in France, Switzerland and Scotland on international commercial arbitration.

<sup>162</sup> See however the recent article by the late Gillis Wetter and the statistics referred to therein which casts some doubts as to the absolute accuracy of claims of popularity of arbitration:

"Among widely held beliefs are that on a global basis the use of contractual provisions for arbitral dispute resolution is on the increase, that international arbitration as a consequence is a growth business and that this feature is the product both of increasing international trade, investment and financial intercourse and confidence in the arbitral process as a better method to restore international disputes than available alternatives. There exists no reliable means of ascertaining whether any of those propositions are true. The same applies to derivative conclusions such as the thesis that there exists no direct casual link between boom or bust in business conditions and volume trends in the initiation of proceedings. Since those and other elementary starting-points are impossible to establish more sophisticated and meaningful inquiries into quantitative and qualitative aspects are tainted with even greater uncertainty, such as trends in the selection of national venues, relative weight of institutional versus non-institutional arbitration, industry-wide preferences, and causes of changes in such trends. Neither logic nor wishful thinking is a substitute for facts." Gillis Wetter, J., *The Internationalisation of International Arbitration*, (1995) 11(2) *Arb.Int.* 117 at 124.

<sup>163</sup> Craig *et al*, *supra*, note 158 at 4.

<sup>164</sup> This, in principle, is achieved through introduction of model contract terms and practices in the areas relevant to international business. See for example *ICC Uniform rules for a combined transport document*, Paris: International Chamber of Commerce: ICC publication; no.298, 1975; *ICC uniform customs and practice for documentary credits*, Paris: I.C.C. Publishing, ICC publication no.500, 1993.

what became the New York Convention was prepared by the ICC to create an international system of recognition of arbitral awards free from the intervention of national courts and therefore of national public policy requirements.<sup>165</sup> The arbitration system introduced by the ICC Rules is intended to serve the needs and interests of this desired global network of businessmen.<sup>166</sup> It therefore operates in the context of transnational private transactions.

#### 1.3.4 States and International Commercial Arbitration

State participation in international commercial arbitration may not be necessarily based on the same grounds as those of private parties. In other words, there is a degree of difference in desirability of international commercial arbitration as a method of dispute settlement between states and private parties which is due to their different expectations from a dispute settlement process:

The expectation of States differs very considerably from those of private parties who resort to commercial arbitration. Here it may be as well to remember that, unlike the situation of the private party who chooses flexibility of the arbitral process as an escape from the strict requirements of litigation, arbitration in any form is for the State a loss of liberty, an acceptance of constraints from which it is otherwise free.<sup>167</sup>

In order to further understand State attitudes towards international commercial arbitration, a brief study of the historical background of state contracts dispute settlement in general is necessary. Such a study points to the fact that the majority of state contract disputes were dealt with by either state courts or international, as opposed to private, arbitral tribunals. State contracts often involve the foreign private party's investment and work on a project conducted in the territory of the state party. According to the concept of territoriality in international law, an alien by entering the territory of a foreign state is presumed to have submitted to the jurisdiction of the local courts.<sup>168</sup> Host states, in principle, consider their courts the most appropriate forum for the resolution of disputes arising out of their contracts with foreign private

<sup>165</sup> As will be seen in other parts of this work, the international business community has been able to influence national legislations on international commercial arbitration in limiting the role of national public policies on arbitration.

<sup>166</sup> Generally, see Craig *et al*, *supra*, note 158.

<sup>167</sup> Fox, H., *States and the Undertaking to Arbitrate*, (1988) 37 ICLQ 1 at 4.

<sup>168</sup> Brownlie, *Principles of Public International Law*, Oxford:Clarendon 1990, 2nd ed., 298-9.

parties.<sup>169</sup>

On the other hand, states are under various obligations laid down by international law as to the treatment of aliens, breach of which would engage the international responsibility of the state, where the home state of the injured alien may make a claim against the state in breach.<sup>170</sup> A breach of contract if not remedied in the courts of the state party could cause an injury to the alien which, in turn, could be the basis for a claim pressed on behalf of the injured party by his home state.<sup>171</sup> Such a claim is an international claim of the state of nationality of the alien; it is that state which would decide whether and how to pursue the claim.<sup>172</sup> The distinct feature of mechanisms used by states to deal with international claims including mixed claims commissions and claims tribunals is that they are established according to an interstate agreement (i.e. an international law instrument), and their jurisdiction is limited to the extent agreed on by the government parties.<sup>173</sup>

A great number of international claims have been decided by mixed claims commissions and tribunals.<sup>174</sup> The extent of participation of individual claimants in the proceedings depends on the agreement of the government parties. For example, an almost total control by the states over proceedings was provided by the Convention and Procedural Rules of the US-Mexican Commission.<sup>175</sup> Commissioners, agents and counsel were appointed by the governments.<sup>176</sup> The decisions of the Commission were

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<sup>169</sup>Indeed, the introduction of Calvo Clause by the Latin American countries was mainly motivated by their desire in excluding the jurisdiction of international tribunals from adjudication of claims arising originally from contracts of states with aliens. This clause embodies a waiver by the aliens of diplomatic protection. Garcia Amador, *supra*, note 7 at 2.

<sup>170</sup>Akehurst, M., *A Modern Introduction to International Law*, London:Unwin Hyman 1987, 88.

<sup>171</sup>See in general Borchard, E., *Diplomatic protection of citizens abroad*, *supra*, note 7.

<sup>172</sup>*The Mavrommatis Palestine Concessions*, (1924) PCIJ Series A 2 at p. 12; Borchard observes: Diplomatic protection is in its nature an international proceeding. When a citizen appeals to his government to demand redress from a foreign government in his behalf, he thereby voluntarily makes his claim a subject of international negotiation independent of his control..." Borchard, E., *ibid.* at 357.

<sup>173</sup>Commissions established following the "Jay Treaty" of 1794 is said to be one of the earliest of international claims tribunals in modern time. Hudson, M. O., *International Tribunals Past and Future*, Washington, D.C.:Carnegie Endowment for International Peace and Brookings Institutions 1944 at 3.

<sup>174</sup>For example, 3000 claims were brought before the Polish-German Commission and 10,000 before the Anglo-German Commission. Hudson, *ibid.* at 8.

<sup>175</sup>The text of the Conventions reproduced in Feller, A. H., *The Mexican Claims Commissions 1923-1934: A study of the law and procedure of international tribunals*, New York: Kruas 1935.

<sup>176</sup>Art.III of the General Claims Convention.

final and conclusive.<sup>177</sup> All claims were to be filed by the governments or by their agents and payments were to be made to the governments and not to the individual claimants.<sup>178</sup> The only part played by the individual claimant was signing the memorial.<sup>179</sup> In contrast, the Claim Settlement Agreement concluded between Iran and the United States<sup>180</sup> providing for the establishment of the Iran-US Claims Tribunal, and the Procedural Rules of the Tribunal<sup>181</sup> provided for a wide range of rights for the individual claimants which makes the Tribunal, in that respect, similar to a private international arbitration.<sup>182</sup>

National claims commissions too have dealt with claims of individuals against foreign states.<sup>183</sup> They should not however be confused with international tribunals and mixed claims commissions. National claims commissions generally function after the conclusion of a lump-sum or 'en bloc' settlement agreement, through which states settle claims of their nationals against other states by obtaining a lump sum. State parties may express the mode of distribution of funds in the agreement.<sup>184</sup> It is to be noted that under this kind of arrangement the task of adjudication of claims is given to

<sup>177</sup> Art.VIII of the General Claims Convention.

<sup>178</sup> Art.IX of the General Claims Convention.

<sup>179</sup> Feller, *supra*, note 135 at 87-88. In practice, however, such commissions showed more flexibility in favour of the individuals on whose behalf the claims were presented as is seen in the Administrative Decision No. V of the US-Mexican Claims Commission: "... Where a demand is paid on behalf of a designated national, and an award and any payment is made on that specific demand, the fund so paid is not a national fund in the sense that the title vests in the nation receiving it entirely free from any obligation to account to the private claimant, on whose behalf the claim was asserted and paid and who is the real owner thereof." reproduced in Feller at 84.

<sup>180</sup> The Declaration of the Government of Algeria Concerning the Settlement of Claims by Iran and the United States (The Claims Settlement Agreement), (1981) 20 ILM 230.

<sup>181</sup> Text of the Tribunal Rules reprinted in (1983)2 Iran-US CTR 405.

<sup>182</sup> According to the Tribunals Procedural Rules, introduction and definitions: 'arbitrating party' means in a particular case, the party or parties initiating recourse to arbitration (the claimant), or the other party or parties (the respondent). The 'arbitrating party' also means one of the two governments when in a particular case, it is a claimant or respondent, or when it refers a dispute or question to the Tribunal pursuant to the Algiers Declaration. Claims of nationals can be directly presented to the Tribunal by the individual claimants as long as the amount of claim is more than \$250,000. (Art.III Para. 3 of the Claims Settlement Agreement) Furthermore, private individual claimants have the right to attend hearings and to be heard.(The Provisionally Adopted Rules of the Tribunal, Definitions) They have also the right to settle their disputes with respondents out of the Tribunal. Rights of private claimants in the Tribunal and almost the entire scheme which the Tribunal follows in its procedure are not of much similarity to those in other claims tribunals and mixed commissions which were to deal with cases of state responsibility for the treatment of aliens.

<sup>183</sup> See generally Lillich, R., *International Claims: Their Adjudication by National Commissions*, Syracuse University Press 1962.

<sup>184</sup> *Ibid.* at 13.

the claimant state, and hence the question of determination of liability of state party under international law is often avoided.<sup>185</sup>

From the viewpoint of an alien claimant, the problem with pursuing a claim through diplomatic intervention is that since the alien's title to protection is not a legal right but an extraordinary legal remedy, it is within the discretion of his own government to pursue the claim and no legal means exists to force the government to do so.<sup>186</sup> In this respect, "the government acts politically upon its own responsibility as a sovereign, free from any legal restrictions by or legal obligations to the claimant."<sup>187</sup> The decision of the state whether or not to negotiate an agreement for the settlement of the claims of its nationals, and on the terms of such an agreement, may be influenced by political considerations and the state's bargaining position vis-a-vis the foreign state.<sup>188</sup> The highly political nature of agreements providing for the establishment of these commissions and the manner in which their decisions were enforced, which sometimes involved military intervention by the home state of the alien, led to strong skepticism towards such forms of dispute settlement among many Latin American nations. Siqueiros observes:

The experience of Latin American countries with claims commissions at the turn of the century was subsequently negative. These commissions ruled on claims submitted by foreign governments for losses suffered by their nationals. They resulted in the payment of substantial indemnifications by Latin American governments and in the loss of territory. Mexico, in particular, had a very painful experience with the awards resulted from the claims commissions. Their enforcement was achieved through foreign military intervention. When the awards favoured Mexican interests, they were met with refusals to comply.<sup>189</sup>

To avoid the problem of politicisation of disputes states may enter into bilateral and multilateral treaties which provide for a legal framework for the settlement of future investment disputes between foreign investors and states.<sup>190</sup> Such treaties provide for reciprocal commitments by state parties with respect to their contracts with nationals of

<sup>185</sup> Seidl-Hohenveldern, *International Economic Law*, Dordrecht; Boston; London: Martinus Nijhoff 1989., 147.

<sup>186</sup> Borchard, *supra*, note 7 at 356.

<sup>187</sup> *Ibid.*

<sup>188</sup> Bowett, D.W., *State Contracts with Aliens: Contemporary Developments on Compensation for Termination or Breach*, (1988) LIX BYIL 49 at 65-6.

<sup>189</sup> Siqueiros, J. L., *Arbitral Autonomy and National Sovereign Authority in Latin America*, In *Lex Mercatoria and Arbitration*, Edited by T. E. Carbonneau, New York: Transnational Juris Publication Dobbs Ferry 1990, 183 at 183-184.

<sup>190</sup> Pogany, I., *Bilateral Investment Treaties*, (1987) 2 ICSID Rev.-FILJ, 457 at 467.

other contracting states often including an undertaking to submit disputes arising out of such contracts to arbitration.<sup>191</sup> Thus a breach of the investment agreement by the host state would amount to a breach in international law of its commitment to the home state of the investor.<sup>192</sup> The effect of the existence of a bilateral treaty on arbitration, where the treaty provides for direct arbitration between the State and the investor, is that in the case of dispute the investor could have direct access to an already provided-for arbitration.<sup>193</sup> In other words, the foreign investor has no need to seek the intervention of his home state after the dispute has arisen. A failure by the defendant state to participate in the arbitration or to comply with the award resulting from such an arbitration would involve the international responsibility of that state. Therefore, these types of arbitration produce a somewhat more secure remedy to the foreign investor.<sup>194</sup>

#### 1.3.4.1 ICSID Arbitration

Following an initiative by the World Bank, the International Convention on the Settlement of Investment Disputes (ICSID) between States and Nationals of other States was adopted.<sup>195</sup> The introduction of the Convention was based on a belief in the beneficial aspects of the flow of foreign investment to developing countries and the fact that, in order to secure this flow, sufficient assurances had to be given to the foreign investor.<sup>196</sup> The Convention, in effect, creates the possibility of direct access to an international tribunal for the foreign investor<sup>197</sup> without having to exhaust local

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<sup>191</sup> *Ibid.*

<sup>192</sup> *Ibid.* at 468-477.

<sup>193</sup> Most of bilateral treaties provide for arbitration between respective states, and not for direct arbitration. Böckstiegel, K. H., The legal rules applicable in international commercial arbitration involving states or state-controlled enterprises, In *60 Years of ICC arbitration: a look at the future*, Paris: ICC Publishing S.A. 1984, 117 at 125.

<sup>194</sup> Sornarajah, *supra*, note 106 at 47.

<sup>195</sup> Convention of 18 March 1965 signed in Washington. United Nations Treaty Series (1966) Vol. 575, p.160, No.8359; For a general commentary see Broches, A., The Convention on the settlement of Investment Disputes between States and Nationals of other States . (1972) 136 RCADI 331.

<sup>196</sup> Sornarajah, *supra*, note 106 at 43.

<sup>197</sup> See *Attorney General of New Zealand v. Mobil Oil New Zealand Ltd.*, Decision of the High Court of New Zealand 25 June 1987 produced in 2 ICSID Rev.-FILJ 297 rejecting the argument that the New Zealand courts should establish the existence of an ICSID arbitration agreement before the dispute could be referred to ICSID.

remedies in the courts of the host state.<sup>198</sup> The ICSID contribution to further protection of foreign investors is achieved by placing at their disposal a remedy which is equivalent to diplomatic protection (already available to them) which is less problematic to seek.<sup>199</sup>

Much has been written on the contribution of ICSID and the question of the extent to which it meets its underlying objectives.<sup>200</sup> Some writers have claimed that ICSID's success consists in introducing a dispute settlement regime representing the interest of both sides concerned in an equal manner.<sup>201</sup> They regard the fact that there have been a relatively small number of disputes referred to ICSID tribunals as evidence of the effectiveness of the system as a deterrent.<sup>202</sup> However, others have expressed the view that the ICSID regime has, on the whole, promoted mainly the foreign investors' interests, and thus it has not stood up to its declared underlying objectives.<sup>203</sup> They argue that the ICSID regime is "a product of its time reflecting the classical approach of international law to the protection of foreign investment"<sup>204</sup> which focussed solely on protecting the interests of foreign investors. It fails to "provide any means for the regulation of the conduct of private investors during the duration of the contract."<sup>205</sup>

More specifically, it has been claimed that the Convention gives the investor party to an agreement providing for ICSID arbitration the status of a subject of international law in which case the investor may directly invoke the international responsibility of the state.<sup>206</sup> Proponents of this view support their assertion by reference to the ICSID

<sup>198</sup> According to Art.26 of the Convention "[C]onsent to arbitration ... shall, unless otherwise stated, be deemed consent to such arbitration to the *exclusion of any other remedy*. A Contracting State *may require the exhaustion of local administrative or judicial remedies* as a condition of its consent to arbitration under this Convention." (Italics supplied)

<sup>199</sup> Seidl-Hohenveldern, *supra*, note 185 at 73.

<sup>200</sup> Broches, A., *supra*, note 195 at 331-410, Delaume, G., 'ICSID arbitration, In *Contemporary problems in international arbitration*, Edited by J. Lew, London:1986, 23; Shihata, I., 'Towards a Greater Depoliticisation of Investment Disputes: The Role of ICSID and MIGA', (1986) 1 ICSID Rev.-FILJ 1; Toope, S., *Mixed International Arbitration: Studies in Arbitration between States and Private Persons*, Cambridge:Grotius 1990, Ch VII.

<sup>201</sup> Broches, *ibid*.

<sup>202</sup> *Ibid.* at 374.

<sup>203</sup> Kuusi, *supra*, note 14 at 147.

<sup>204</sup> *Ibid.*

<sup>205</sup> *Ibid.*

<sup>206</sup> Broches, *supra*, note 195 at 349.

scheme of arbitration which gives the private party direct access to the tribunal.<sup>207</sup> It is argued that this excludes the right of the diplomatic protection of the home state of the investor.<sup>208</sup> They also explain the fact that an ICSID tribunal's awards cannot be appealed against in national courts.<sup>209</sup> On the other hand, it may be argued that rights of foreign investors under the ICSID regime derives from a treaty whereby the Contracting States, in the framework of diplomatic protection, have agreed to give their nationals full control over their claims with regard to investment disputes with foreign states.<sup>210</sup>

The nature of the role of the foreign investor and some provisions of the Convention, such as the one relating to the question of the applicable substantive law,<sup>211</sup> have been subject to different interpretations.<sup>212</sup> Perhaps, in order to avoid the difficult, if not impossible, task of reconciling the conflicting views of different states in a single document, the drafters of the Convention decided to address the above matters in an ambiguous manner.<sup>213</sup>

On the whole, and notwithstanding its shortcomings, the ICSID regime is regarded as a step forward in bringing the settlement of investment disputes within a judicial framework, in that, it has, to some degree, accomplished the goal of depoliticising such disputes.<sup>214</sup> The participation of the developing states in the formulation of the Convention has been mentioned as a factor contributing to its credibility.<sup>215</sup> All the

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<sup>207</sup> *Ibid.*

<sup>208</sup> *Ibid.*

<sup>209</sup> Seidl-Hohenveldern, *supra*, note 185 at 13.

<sup>210</sup> See above, notes 174-182 and accompanying text.

<sup>211</sup> Art.42(1) of the Convention.

<sup>212</sup> See chapter IV, *infra* at 132-133, 160-164.

<sup>213</sup> Schwarzenberger, G., The Arbitration Pattern and Protection of Property Abroad, *In International Arbitration: Liber Amicorum for Martin Domke*, Edited by P. Sanders, The Hague: Martinus Nijhoff 1967, 313, 319-320.

<sup>214</sup> Shihata, I., Towards a Greater Depoliticization of Investment Disputes: The Role of ICSID and MIGA, (1966) 1 ICSID Rev.-FILJ, 1.

<sup>215</sup> Sornarajah, *International Commercial Arbitration*, *supra*, note 106 at 97-98. Other arguments in favour of ICSID arbitration as distinct from other kinds of arbitrations include: (i) it was introduced by states and not private businesses. Many states, both developing and developed, participated in the preparatory work of the Convention; (ii) The draft of the Convention was prepared by the World Bank, an international organisation, which compared to private institutions is better placed to understand the needs of states with different socioeconomic backgrounds; (iii) The Convention was not the result of bilateral negotiations between two states which, as already noted, could be influenced by the bargaining positions of those states vis-a-vis one another.

above methods of dispute settlement have their origin in international law; they are, in principle, interstate arbitration dealing with international claims. Resort to private arbitrations, *ad hoc* and institutional, has been relatively a new practice.<sup>216</sup> The natural approach of states towards arbitration of their disputes with private parties within a private law context has been one of caution and restriction. This is due to their past experience and their states' uncertainty in the ability of an institution of private law to deal with cases with public law aspects. Many states are suspicious of the process and see it as one which mainly serves the interest of private parties.<sup>217</sup> In many countries, the state and/or its organs are restricted or prohibited from concluding arbitration agreements with foreign parties.<sup>218</sup> It is often in the face of the strong bargaining position of the private parties that states agree to arbitration.

#### 1.4 Conclusion

The ability of international commercial arbitration to respond to various needs of international trade and investment and the overall object of the stability of contractual relations have no doubt been among factors accounting for its popularity with the main recipient of its service i.e. the international business community. More specifically, arbitration laws and conventions have been able to take the dispute settlement away from the influence of national public policies. This is in line with the fundamental goal of internationalisation of the regulation of international contracts and the settlement of disputes arising therefrom. A case is made for further adjustment of international

<sup>216</sup> *Lena Goldfields v. USSR* in Nussbaum, *The Arbitration Between the Lena Goldfields Ltd. and the Soviet Government*, (1950) 36 Cornell L.Q. 31-36; *Petroleum Development Ltd. v. The Sheikh of Abu Dhabi*, The Decision of the Umpire September 1951 (1951) 18 ILR 144 at 149; *Ruler of Qatar v. International Marine Oil Company* (1953) 20 ILR 534 at 545; *Sapphire International Petroleum Ltd. v. National Iranian Oil Company* (NIOC), Award of 15 March 1963, 35 ILR 137 at 170-6; *Texaco Overseas Petroleum Company and California Asiatic Oil Company v. The Libyan Arab Republic*, Awards of 27 November 1975 and 19 January 1977 (Merits), 53 ILR 389 at 453.

<sup>217</sup> See generally Sornarajah, *International Commercial Arbitration*, *supra*, note 106, Chapter one; for a contrary view see Paulsson, J., *Third World Participation in International Investment Arbitration*, (1987) 2 ICSID Rev.-FILJ 19.

<sup>218</sup> In Spain, for example the State and its agencies may only submit their disputes to arbitration following an authorisation by a decree. See in general, Cremades, *National Report on Arbitration: Spain*, In *Handbook Commercial Arbitration*, Ed. by P. Sanders, Kluwer. According to the Saudi law, in principle, the state is not allowed to submit its disputes with foreigners to arbitration unless special permit has been granted by the Council of Ministers. See Van den Berg, A., *National Report on Arbitration: Saudi Arabia*, *ibid.*

commercial arbitration, through its delocalisation whereby the controlling role of national public policies on arbitration is further limited.

However, the question this work is primarily concerned with is the propriety of this kind of arbitration as a method of state contracts disputes settlement where, in the light of the dual function of the state party and the involvement of public interest, there is a need, recognised by national and international law, for the flexibility in the legal regime of contracts.

This work follows a classical structure, in that, various aspects of arbitration including jurisdictional issues, questions of control and procedural remedies, substantive law, remedies and recognition and enforcement of awards will be studied. In particular, the effects of the developments in national laws on the arbitration of state contracts disputes will be considered. As well as international commercial arbitration, this work will cover other types of state contracts arbitrations including treaty-based arbitrations such as those conducted within the regimes of the ICSID and the Iran-US Claims Tribunal.

## Chapter II

### Jurisdictional Issues

#### 2.1 Introduction

This chapter deals with the jurisdiction of arbitral tribunals and related issues. State parties, as noted in the previous chapter, generally take a restrictive view of arbitration. More specifically, in the light of their public policy importance, the state may desire to keep disputes relating to certain areas away from the jurisdiction of arbitral tribunals. In the case of states party to contracts, such matters could be specifically related to economic activities which the state may enjoy certain sovereign discretions. Private parties however following their universalist view of regulation of international contracts and international commercial arbitration, favour a minimum level of national public policy limitations on arbitration. Against this background, a number of matters concerning jurisdiction of arbitral tribunals will be studied.

#### 2.2 Arbitration Agreement

An arbitral tribunal derives its power from the agreement of the parties to submit to arbitration. It is this agreement which sets the limits of the arbitrator's jurisdiction and defines the subject-matter of the arbitration. An arbitration agreement could be in the form of an arbitration clause as part of a main contract, referring future disputes to arbitration.<sup>1</sup> Alternatively, the arbitration agreement could be in the form of a submission agreement referring already existing dispute(s) to arbitration.<sup>2</sup> Some countries do not recognise as valid, arbitration clauses, for they are viewed as being in derogation of the rights of individuals to go to court.<sup>3</sup> Consent is the cornerstone of an arbitration agreement, without which there could be no arbitration. National laws, in

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<sup>1</sup> Redfern, A. & Hunter, M. *Law and Practice of International Commercial Arbitration*, London: Sweet and Maxwell 1991, 130.

<sup>2</sup> *Ibid.* In practice, there are submission agreements agreed upon subsequent to the conclusion of the contract containing an arbitration clause. This is usually to choose the arbitrator, if it has not been done before, to set the procedure to be followed by the arbitral tribunal and to further define the scope of the arbitration clause which might otherwise have been too general.

<sup>3</sup> E.g. according to the Saudi Arabian Council of Ministers Resolution No.58 (2): "it is not permitted for all Governmental bodies to accept arbitration as method for settlement of disputes which may arise between it and contracting individuals and companies." Van den Berg, A., National Report on Arbitration: Saudi Arabia, In *Handbook Commercial Arbitration* (looseleaf), Edited by P. Sanders, Deventer: Kluwer, 9.

general, recognise the parties' freedom to refer their disputes to arbitration. They are usually prepared to assist arbitration and provide it with a large degree of latitude to conduct its functions.<sup>4</sup> Consent, in the context of certain state contracts arbitrations may take a different form from that in private arbitrations.

Consent to the jurisdiction of an ICSID tribunal has two stages.<sup>5</sup> The Contracting States have to agree at an international level to the provisions of the Washington Convention providing for the jurisdiction of the Centre.<sup>6</sup> In a given case, however, there also has to be the consent of the parties to an arbitration i.e. the state party and the foreign investor.<sup>7</sup> Once the parties have consented to ICSID jurisdiction, they may not unilaterally withdraw their consent.<sup>8</sup>

Consent of the parties in the Iran-US Claims Tribunal is peculiar to that arbitration. Under the Algiers Accords, the Tribunal has exclusive jurisdiction over all claims of nationals of one of the two states against the other state and any such claims and counterclaims which may arise out of the same contract, transaction or occurrence unless contractual clauses specifically provide for the sole jurisdiction of Iranian courts.<sup>9</sup> Thus, the respective states of the arbitrating parties have, at an international level and by the virtue of a treaty, removed certain categories of claims from the ordinary jurisdiction of their courts and placed them within the jurisdiction of an international tribunal i.e. the Iran-US Claims Tribunal.<sup>10</sup>

— Member states of the Council for Mutual Economic Assistance (CMEA) agree to provide for a type of compulsory jurisdiction for arbitral tribunals over some

<sup>4</sup>For the discussion of national law and arbitration see *infra*, 1.3.3.

<sup>5</sup> See Lamm, C., Jurisdiction of ICSID, (1991) 6 ICSID Rev.-FILJ 462 ; Tupman, M., Case studies in the jurisdiction of the International Centre for Settlement of Investment Disputes, (1986) 38 ICLQ 813.

<sup>6</sup> 1965 Washington Convention on the Settlement of Investment Disputes between States and National of other States, March 18, 1965, U.N.T.S. (1966) Vol.575, 160.

<sup>7</sup> Art.25(1).

<sup>8</sup> *Ibid.*

<sup>9</sup> Art.II, The Declaration of the Government of Algeria Concerning the Settlement of Claims by Iran and the United States, January 1981, reprinted in (1981) 20 ILM 230.

<sup>10</sup> For a discussion of the legal nature of the Tribunal see Chapter III , *infra*, 3.4.2.

categories of disputes.<sup>11</sup> Under the provisions of the Moscow Convention of 1972 all civil disputes between the enterprises of the members of CMEA, which are connected with economic, scientific and technical co-operation are under the obligatory competence of the Court of Arbitration at the Chambers of Commerce and Industry in the CMEA countries.<sup>12</sup>

Following their supportive attitude towards international commercial arbitration, in order to facilitate the commencement and operation of arbitration in the face of jurisdictional objections, a number of national laws have adopted doctrines of autonomy of arbitration agreement and competence-competence.

### 2.3 Autonomy of Arbitration Agreement

This is a relatively new concept in the law and practice of international arbitration—public and commercial arbitration. It considers the arbitration clause as an agreement separate from the main contract of which the clause is a part.<sup>13</sup> The concept is referred to as the doctrine of autonomy, separability<sup>14</sup> or severability<sup>15</sup> of arbitration agreement. The importance of the doctrine lies in the fact that a great number of claims are brought to arbitration after the termination of a contract. It would be pointless to have an arbitration clause which would not be operative to cover disputes relating to such contracts upon their termination. It is argued that the parties to a contract containing an arbitration clause, which refers to arbitration any disputes arising out of or relating to their agreement, in fact intend to submit all disputes, including those relating to the validity of the contract, to arbitration.<sup>16</sup> Furthermore, it is claimed that parties, by entering a contract containing an arbitration clause, enter into two agreements:

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<sup>11</sup> Convention on the Settlement by Arbitration of Civil Law Disputes Resulting from Relations of Economic and Scientific-Technical Cooperation, May 26th, 1972 reprinted in Sanders, P., *Handbook on Commercial Arbitration*, *supra*, note 3, Vol.I.; also Commentary in Strohbach, H., The CMEA countries, In *Arbitration in Settlement of International Commercial Disputes involving the Far East and Arbitration in Combined Transportation*, Edited by P. Sanders 133, 1989 Deventer: Kluwer.

<sup>12</sup> Stalev, Z., National Report on Arbitration: Bulgaria, In *Handbook Commercial Arbitration*, *supra*, note 3, at 2.

<sup>13</sup> Redfern & Hunter, *supra*, note 1 at 174-176.

<sup>14</sup> Svernlöv, C., What Isn't, Ain't: The Current Situation of the Doctrine of Separability, (1991) 8 *Journal of International Arbitration* 37.

<sup>15</sup> Schwebel, S., *International Arbitration: Three Salient Problems*, Cambridge: Grotius 1987 at chapter I.

<sup>16</sup> *Ibid.* at 3.

"... first, the substantive or principal agreement which provides for a certain course of action; second, an additional, separable agreement which provides for arbitration of disputes arising out of the principal agreement. Even if it be argued, or even if it be authoritatively decided, that the principal agreement is invalid, or voided, nullified, terminated, or suspended, nevertheless the arbitral agreement is separable and separated, and, so separated, survives to furnish a viable basis for the arbitration tribunal to rule upon such arguments or arrive at those or other determination."<sup>17</sup>

The finality of the arbitrators' decision on the substance of a dispute i.e. the award is a requirement of an effective arbitration. To consider the arbitration agreement as separable from the main agreement would enable the arbitrator to rule on the validity of the principal agreement and decide the case on its merits without courts being "drawn into passing judgment upon the substance of the dispute submitted to arbitration."<sup>18</sup>

The doctrine has been challenged on the basis that it "contains a large element of legal fiction".<sup>19</sup> If the agreement containing an arbitration clause is invalid or no longer in force, the obligation to arbitrate disappears, and if the agreement was never entered into, there can be no arbitration. An arbitration agreement derives its validity from the contract it is a part of. A void or a non-existent contract cannot be a legal basis for a valid arbitration clause. Proponents of the doctrine, in contrast, argue that since it is inherent in the arbitral process that the tribunal is the judge of its own jurisdiction, it should have the competence to pass judgment upon disputes arising out of the agreement which is the immediate source of the tribunal's creation even where those disputes relate to the initial or continuing validity of that agreement.<sup>20</sup>

Apart from the theoretical basis of the doctrine, what is important to consider is its material scope in relation to the sources of the invalidity of the contract. In principle, three kinds of situation may be distinguished. First, where the applicability of the doctrine in a contract that was never entered into is claimed. This could be the case, for instance, in a contract signed by a party who lacked capacity. Second, when the initial validity of the contract is disputed. Third, when the termination or supervening invalidity of the contract is alleged as the basis for the non-operation of the arbitration

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<sup>17</sup> *Ibid.* at 5.

<sup>18</sup> *Ibid.* at 6.

<sup>19</sup> Wetter, J.G., *Salient Features of Swedish Arbitration Clauses*, (1983) *Yearbook of the Arbitration Institute of the Stockholm Chamber of Commerce* 33.

<sup>20</sup> Schwebel, *supra*, note 15 at 38

clause.<sup>21</sup> The doctrine's acceptance has been mainly in the case of contracts valid up until the dispute has arisen (voidable), and to a lesser extent those whose initial validity is challenged (void).<sup>22</sup> The applicability of the doctrine to contracts which never came into force could have far reaching effects and for that reason is not so widely accepted. The doctrine has been adopted by jurisdictions which are supportive of arbitration, the rules of arbitration, and international conventions and has been applied to public and private arbitrations.

Art.16(1) of the UNCITRAL Model Law embodies doctrines of competence-competence and separability. Having acknowledged the power of the arbitrator to rule on his jurisdiction, it provides: "... For that purpose, an arbitration clause which forms part of a contract shall be treated as an agreement independent of the other terms of the contract. A decision by the arbitral tribunal that the contract is null and void shall not entail *ipso jure* the invalidity of the arbitration clause." Therefore, faced with a challenge to the validity of the contract, the arbitral tribunal continues to have jurisdiction to decide on the challenge and other issues "unless it finds that the defect which causes the nullity of contract affects also the arbitration clause itself."<sup>23</sup> The scope of the doctrine of separability under the Model Law is thus much wider than in some national laws.

In English law the separability doctrine has gained acceptance for voidable contracts but the case of void contracts is not settled.<sup>24</sup> In *Paul Smith v. H&S International Holdings Co. Inc.*, an English Judge considered the possibility of applying the doctrine to the allegedly *ab initio* invalid contract so that the arbitrator might have the

<sup>21</sup> E.g. *Heyman v. Darwins Ltd.* [1942] AC 356.

<sup>22</sup> Using the terminology of Svenlov. See Svenlov, *supra*, note 14 at 38.

<sup>23</sup> Holtzmann, H., *A guide to the UNCITRAL Model Law on International Commercial Arbitration: legislative history and commentary*, Deventer/The Hague:Kluwer 1989, 508.

<sup>24</sup> On the nature of arbitration clause House of Lords has ruled: "The arbitration clause constitutes a self contained contract collateral or ancillary to the shipping [main] contract itself." *Bremer Vulkan Schiffbau Und Maschinenfabrik v. South India Shipping* [1981] 1 LLR 253 at 259; [1981] A.C.909 at 980. Also *Heyman v. Darwins Ltd.* [1942] AC 356.

power to decide on this question.<sup>25</sup> Later, in *Harbour Assurance Co.(UK) Ltd. v. Kansa General International Insurance Co.Ltd.*, the same judge stated *obiter* that the arbitration clause could survive the *ab initio* invalidity of the principal agreement.<sup>26</sup> The court, however, did distinguish between the *ab initio* invalidity and illegality and limited its acceptance of the doctrine to the former.<sup>27</sup> On appeal, the Court of Appeal extended the scope of the doctrine also to initial illegality.<sup>28</sup> According to English law, the doctrine does not apply to contracts whose existence has been challenged, and therefore, only a court of law can decide on the question:

“It has been decided and is a principle of law that an arbitrator does not have jurisdiction, nor can the arbitration agreement be construed to give him jurisdiction to rule upon the initial existence of the contract.”<sup>29</sup>

In the United States, the acceptance of the doctrine extends to void and voidable contracts.<sup>30</sup> When the existence of the contract itself is challenged, only courts can decide on the validity of the contract including that of the arbitration clause; therefore,

<sup>25</sup> Justice Steyn held: “Admittedly, no English Court has yet been asked to take the final step of ruling that an arbitration clause, which forms part of a written contract, may be wide enough to cover a dispute as to whether the contract was valid *ab initio*. An arbitration agreement separately... at the same time as the principal contract is capable of conferring authority on arbitrator to decide an issue as to the validity *ab initio* of the contract. If that is so, why should the same not apply to the arbitration agreement which physically forms part of the contract? After all, it has been recognised as having independent existence. But I am not asked to take this final step in this case.” [1991] 2 LLR 127, at 130; Commentary of the case see Svernlöv, C., *The Evolution of the Doctrine of Separability in England: Now Virtually Complete?*, (1992) 8 *Journal of International Arbitration* 115-121.

<sup>26</sup> [1992] 1 LLR 81 at 93.

<sup>27</sup> *Ibid.*; The non-applicability of the doctrine of separability to a contract whose legality has been challenged was emphasised in *Dalmia Dairy Industries Ltd. v. National Bank of Pakistan* where it was held: “... it is the law of ... England that just as a dispute whether a contract existed is not within the arbitration clauses in the alleged contract sought to be established, so a dispute whether a contract admitted to exist was illegal at the time of its conclusion and therefore void *ab initio* does not fall within such a clause” [1978] 2 LLR 223.

<sup>28</sup> [1993] QB 701. Laggatt L.J. stated: In my judgment this court is not obliged by the authority to prevent the arbitrator from determining the issue of initial illegality. The tide is flowing in favour of permitting the arbitrator to do so, and it is no more necessary on the grounds of public policy for the courts to retain exclusive control over the determination of the initial legality of agreements than over their subsequent legality (p. 719).

<sup>29</sup> *Ashville Investment Ltd. v. Elmer Contracting Ltd.*, Court of Appeal, [1988] 2LLR 73 at 75; The answer could be different under Art.3(2) of 1994 English Draft Arbitration Bill provides: “An arbitration agreement which forms part of another agreement (“the primary agreement”) shall in all cases be regarded as constituting (and having constituted since it was made) an agreement which is separate from the primary agreement, and, accordingly, an arbitration agreement shall not be void, voidable, unenforceable or otherwise ineffective by reason that the primary agreement is void, voidable, unenforceable or otherwise ineffective.” Text of the Bill reprinted in (1994) 6(3) *World Trade and Arbitration Material*, 153.

<sup>30</sup> *Prima Paint v. Flood and Conklin* 388 US 395 (1967); also in Svernlöv, *What Isn't, supra*, note 14 at 43-4.

in such a situation an arbitration clause is not separable.<sup>31</sup> Furthermore, when the validity of the arbitration clause, as opposed to the main agreement is challenged, the issue can only be decided by a court.<sup>32</sup> The position under French law seems to be the same as that in the United States for although there is no reference to the doctrine in the legislation, it has been ruled by courts that the arbitration agreement is autonomous from the main agreement in international commercial arbitration.<sup>33</sup>

Rules of the Court of Arbitration of the ICC illustrate a more liberal approach on the matter.<sup>34</sup> Article 8.4. of the Rules provides :

"Unless otherwise provided, the arbitrator shall not cease to have jurisdiction by reason of any claim that the contract is null and void or allegation that it is inexistent provided that he upholds the validity of the agreement to arbitrate. He shall continue to have jurisdiction, even though the contract itself may be *inexistent* or *null and void*, to determine the respective rights of the parties and to adjudicate upon their claims and pleas."

According to this article, the arbitrator can decide on the validity of the principal agreement in any case including those in which the existence of such an agreement has been challenged. Moreover, the arbitrator may decide the case and rule on the rights and obligations of the parties upon a finding of nullity or non-existence or invalidity of the contract. He will not have jurisdiction only if *he* decides that the arbitration agreement itself is not valid.

There is no specific reference to the separability of the arbitration clause in the ICSID Convention. It provides for the competence-competence rule<sup>35</sup> and the

<sup>31</sup> *Pollux Marine Agencies Inc. v. Louis Deryfus Corp.*, 455 F.Supp.211 (S.D.N.Y. 1978)

<sup>32</sup> *Three Valley Mun. Water Dist. v. E.F. Hutton and Co.*, 925F.2d, 1136 (9th Cir.1991). "...because an 'arbitrator's jurisdiction is rooted in the agreement of the parties' ... a party who contests the making of a contract containing an arbitration provision cannot be compelled to arbitrate the threshold issue of the existence of an agreement to arbitrate. Only a court can make that decision." 1140-41.

<sup>33</sup> *Societe Gosset v. Societe Carapelli*, Cour de cassation, [1963] D.Jur.545., translation supplied in part in Svernlöv, What Isn't, Ain't, *supra*, note 14 at 45; The authority in the former Soviet Union could be found in the Rules of the Arbitration Court and prior to that in the *Joc Oil case* where, on the question of autonomy of the arbitration clause, it was held: Proceeding from the above analysis of Soviet material and procedural legislation applicable to the dispute in question, the Commission has recognised that an arbitration agreement ( arbitration clause) is a procedural contract, independent from the material-legal contract and therefore the question as to the validity or invalidity of this contract does not affect the agreement of the parties about the submission of the existing dispute to the jurisdiction of the FTAC. *All Union Foreign Trade Association "Soyuzvetexport" v. Joc Oil limited (Bermuda)*, Foreign Trade Arbitration Commission at the USSR Chamber of Commerce and Industry, case no. 109/1980 of 9 July 1984, (1993) 17 YBCA at 105. For the authorities on the acceptance of the doctrine by German, Swedish and Swiss courts see Svernlöv The Evolution of the Doctrine of Separability in England: Now Virtually Complete, (1992) 8(3)Journal of International Arbitration, *supra*, note 25 at 115.

<sup>34</sup> Reprinted in Redfern and Hunter, *supra*, note 1 at 571.

<sup>35</sup> Art.41.

irrevocability of the consent to arbitration.<sup>36</sup> By way of analogy to the latter, it has been argued that a State "is not entitled to vitiate the arbitral process by maintaining that the principle agreement containing the arbitral obligation is void or voided."<sup>37</sup>

The issue of the autonomy of arbitration agreements has been addressed in both interstate and state contract arbitrations.<sup>38</sup> In the *Sapphire Case*, National Iranian Oil Company (NIOC) despite the fact that it had terminated the contract containing an arbitration clause, reserved remedies that it was entitled to under the contract, in that, NIOC did not challenge the continuing validity of the arbitral clause.<sup>39</sup> Libyan nationalisation cases presented arbitral tribunals with another opportunity to consider this issue. The concession contracts in dispute all contained arbitration clauses which, among other things, stated that the sole Arbitrator had the power to determine the applicability of the clause and the procedure to be followed in the arbitration.<sup>40</sup> In *BP*, having considered the concession as terminated, Lagergren maintained that as far as the jurisdiction of the tribunal was concerned it remained in force.<sup>41</sup> Thus, in effect the arbitration clause was treated separately from the rest of the concession contract. Arbitrators in *Topco v. Libya* and *LIAMCO v. Libya* expressly defined and supported the doctrine of separability of the arbitration clause.<sup>42</sup>

The above cases mainly related to situations where the state party claimed that its termination of the contract had ended the operation and the existence of the arbitration clause. In *Elf Aquitaine Iran v. National Iranian Oil Company*, an *ad hoc* arbitration, a

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<sup>36</sup> Art. 25.

<sup>37</sup> Schwebel, *supra*, note 15 at 16.

<sup>38</sup> *Ibid.*

<sup>39</sup> *Sapphire International Petroleum Ltd. v. National Iranian Oil Company*, Award of 15 March 1963, 35 I.L.R. 137 at 159; commentary of the case in Suratgar, D., Considerations affecting choice of law causes between governments and foreign nationals, (1962) 2 IJIL 273-317.

<sup>40</sup> *BP Exploration Company (Libya) Limited v. The Government of the Libyan Arab Republic*, 53 I.L.R. 297 at 303.

<sup>41</sup> *Ibid.* at 354.

<sup>42</sup> The sole arbitrator Dupuy, discussed the question in depth and cited authorities from national laws and international arbitral awards in support of separability of arbitration clause. 53 I.L.R. 389 at 407-412. The arbitrator in *LIAMCO*, Dr. Mahmassani held: "It is widely accepted in international law and practice that an arbitration clause survives the unilateral termination by the State of the contract in which it is intended to continue in force even after that termination. This is a logical consequence of the interpretation of the parties, and appears to be one of the basic conditions for creating a favourable climate for foreign investment." *Libyan American Oil Company (LIAMCO) v. The Government of the Libyan Arab Republic*, 62 I.L.R. 140 at 178.

question arose as to whether a claim that the contract was *ab initio* null and void would undermine the validity of the arbitration clause of the contract.<sup>43</sup> The sole arbitrator held:

"It is a generally recognised principle of the law of international arbitration that arbitration clauses continue to be operative, even though an objection is raised by one of the parties that the contract containing the arbitration clause is null and void. The jurisdiction of an arbitrator or arbitration board designated in accordance with an arbitration clause is unimpaired, even though the contract containing the arbitration clause is alleged to be null and void"<sup>44</sup>

On the applicability of the doctrine to contracts whose existence have been challenged, the Tribunal held:

"An arbitration clause may not always be operative in cases where it is clearly indicated by the facts and circumstances that there never existed a valid contract between the parties. The facts and circumstances that have been made known to the Sole Arbitrator concerning the agreement in the present case do not so indicate..."<sup>45</sup>

The ICC tribunal in *Framatome* took a much wider view of the doctrine according to which it was within the jurisdiction of the arbitral tribunal to decide on its jurisdiction including on the validity and existence of the principal agreement and of the arbitration clause.<sup>46</sup>

## 2.4 Competence/Competence

The doctrine of competence/competence is advanced to resolve another logical jurisdictional problem in arbitration.<sup>47</sup> In order to examine whether, in the face of a challenge, it has jurisdiction, and to see what the limits of such a jurisdiction might be, an arbitral tribunal has to assume that it has jurisdiction. <sup>the need for</sup>

<sup>43</sup> (1986) XI YBCA at 97.

<sup>44</sup> *Ibid.* at 102-3.

<sup>45</sup> *Ibid.*

<sup>46</sup> In this case, the respondent, Atomic Energy Organisation of Iran (AEOI), contested the jurisdiction of the tribunal on the grounds of the nullity of the contract and the arbitration clause due to the incapacity and lack of the proper authorisation of its President in concluding the contract containing the arbitration clause. The Tribunal, having acknowledged that the President of the AEOI had not complied with all the requirements of Iranian law, and that Framatome had been somewhat derelict in not requiring AEOI to produce a legal opinion regarding the validity of AEOI's contractual undertaking, nevertheless held that AEOI was under an obligation to inform its French partners of the requirements of Iranian law. Thus, the Tribunal found that under the general principles of law the AEOI was stopped from challenging the validity of the contract. A similar argument was used by the Tribunal to uphold the arbitration agreement. Award of April, 1982, 8 YBCA 94.

<sup>47</sup>The doctrine is referred to as 'Kompetenz-Kompetenz' in German and 'competence de la competence' in French law.

effective arbitration is suggested as a reason for upholding the principle as it would prevent unmeritorious challenges of jurisdiction being advanced in order to delay or impair the arbitration proceedings.<sup>48</sup> Therefore, similar to the separability principle, a certain degree of legal fiction is involved: convenience is placed ahead of logic.<sup>49</sup> The principle has not been adopted by all national laws and is considered to be somewhat controversial.<sup>50</sup>

Art.16 of the UNCITRAL Model Law provides: "The arbitral tribunal shall have the power to rule on objections that it has no jurisdiction, including any objections with respect to the existence or validity of the arbitration clause or of the separate arbitration agreement."<sup>51</sup> According to the Model Law there is no concurrent jurisdiction for courts to hear a plea that the tribunal lacks jurisdiction. It is only after the tribunal has ruled that it has jurisdiction that the matter could be brought before a court.<sup>52</sup>

In English law the position on the doctrine is found in *Harbour v. Kansa*:

"The approach in English law is simple, straightforward and practical. As a matter of convenience arbitrators may consider, and decide, whether they have jurisdiction or not; they may decide to assume or decline jurisdiction. But it is well settled in English law that the result of such a preliminary decision has no effect whatsoever on the legal rights of the parties. Only the court can definitively rule on issues relating to the jurisdiction of arbitrators."<sup>53</sup>

A decision by the arbitrator as to his jurisdiction is 'provisional', challengeable in English Courts.<sup>54</sup> Furthermore, a party challenging the jurisdiction of an arbitral tribunal does not have to wait until the issue is decided by the tribunal itself. In this sense, there is a concurrent power for courts to decide on the issue. This is similar to the position under German law.<sup>55</sup> However, under the latter, the parties may give the arbitrator the authority to rule definitively on his jurisdiction.<sup>56</sup> Therefore, in principle, the tribunal's decision on its jurisdiction is provisional and courts have a concurrent power to decide on the issue unless the parties have agreed that the arbitral tribunal

<sup>48</sup> Gross, P., Competence-competence: An English view. (1992) 8 *Arbitration International* 205.

<sup>49</sup> *Ibid.*

<sup>50</sup> Seventh UNCITRAL Secretariat Note, A/CN.9/264, Art.16, para.1.

<sup>51</sup> Commentary see Holtzmann, *supra*, note 23 at 478-487.

<sup>52</sup> Art.16(3).

<sup>53</sup> [1992] 1 LLR 81 at 83.

<sup>54</sup> Gross, *supra*, note 48 at 210.

<sup>55</sup> Schlosser, P., The Competence of Arbitrators and of Courts, (1992) 8 *Arbitration International* 189.

<sup>56</sup> *Ibid.* at 202.



should have the 'last word' on jurisdiction.<sup>57</sup>

French law has taken a far more liberal view by giving the arbitral tribunal the exclusive right to decide on its jurisdiction before the proceedings have commenced and the courts must decline jurisdiction as long as the arbitration agreement is not manifestly null and void.<sup>58</sup> Thus the arbitrator has the first word on his jurisdiction and as long as there is no decision by him on the question, there cannot be court proceedings on the validity and scope of the arbitration agreement. This could lead to the unsatisfactory situation whereby a claimant who is aware of the invalidity of the arbitration agreement relating to the cause of action has no right to take his claim to a court of law as long as there is no decision by the arbitral tribunal that it lacks jurisdiction.<sup>59</sup> The mere suggestion of an arguable case for the existence of an arbitration agreement by a would-be defendant in a court case could be a ground to challenge the jurisdiction of the court on the matter.

According to the relevant provisions of the ICC Arbitration Rules, the arbitral tribunal, upon finding for the *prima facie* existence of an arbitration agreement established by the ICC's Court, can decide on its jurisdiction.<sup>60</sup> It has been suggested that the ICC procedure for ascertaining the existence of a valid arbitration agreement may result in situations where an arbitral tribunal is established in the absence of an arbitration agreement between the parties.<sup>61</sup> The tribunal continues to have jurisdiction, regardless of the fact that the contract itself may be inexistent or null and void, to determine the respective rights of the parties and to adjudicate upon their claims and pleas.<sup>62</sup> This, read together with the provisions of Art.13(c)(d) which provides that in the absence of a definition by the parties, the tribunal will have the power to define the claims of the parties and the issues to be determined shows the broad power of arbitrator under the ICC Rules.

By contrast, according to the rules of China International Economic and Trade

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<sup>57</sup> *Ibid.*

<sup>58</sup> Art. 1458, French Code of Civil Procedure, Book IV (Decree Law No 81-500 of May 12, 1981) reprinted in Redfern & Hunter, *supra*, note 1, 750.

<sup>59</sup> Schlosser, *supra*, note 55, at 201.

<sup>60</sup> ICC Rules Art. 8 (3).

<sup>61</sup> Redfern & Hunter, *supra*, note 1 at 212.

<sup>62</sup> Art. 8 (4).

Arbitration (CIETA) follow a more restrictive approach in that, in the case of jurisdictional challenges, it is for the Arbitration Commission to decide on the validity of the arbitration agreements and jurisdiction of the arbitral tribunal.<sup>63</sup>

According to Art.36(6) of the Statute of the International Court of Justice, the Court has the power to decide on its jurisdiction. The history and case law of the Court indicates a shift from a restrictive approach on the question of jurisdiction to a more liberal approach.<sup>64</sup> This however has been attributed to the political role that the Court plays in relation to its function to move the parties toward diplomatic solutions.<sup>65</sup> Art. 41 of the ICSID Convention also embodies this doctrine.<sup>66</sup> Arbitral tribunals dealing with state contract disputes have also repeatedly upheld this principle.<sup>67</sup>

In order to avoid some logical problems in relation to the jurisdictional decisions of the arbitral tribunals, the adoption of doctrines of autonomy of arbitration clause and competence-competence is justified. However, the broad scope given to the doctrines by some national laws may give rise to situations in which a decision by the arbitral tribunal in excess of its power may remain unchallenged, at least in the place of arbitration. The problem in particular may arise in relation to ICC arbitrations where the *prima facie* existence of an arbitration agreement is adequate for the tribunal to decide on the validity of the arbitration agreement and of the principal agreement even in cases where the existence of the latter has been challenged. The effect of the ICC provisions is more evident in jurisdictions which have adopted a 'hands-off' policy towards arbitration, in that the tribunal could have the last word on its jurisdiction.<sup>68</sup> In such jurisdictions there will be no recourse available against the decision of the arbitrator. It would only be possible to challenge a decision in excess of his power in the country of enforcement.<sup>69</sup> This could lead to an unsatisfactory situation where an

<sup>63</sup> Yulin, Z., *Towards the UNCITRAL Model Law: A Chinese Perspective*, (1994) 11 J.Int.Arb. 87 at 109.

<sup>64</sup> Reisman, M., *Systems of Control in International Adjudication and Arbitration*, Durham/London:Duke University Press 1992, 14-27.

<sup>65</sup> *Ibid.* at 26.

<sup>66</sup> Art.41(1) The Tribunal shall be the judge of its own competence.

<sup>67</sup> See, for example, *Sapphire Award*, 35 ILR 137 at 168; *Elf Aquitaine Iran v. National Iranian Oil Company*, (1986) XI YBCA 97 at 98.

<sup>68</sup> E.g. Belgium and Switzerland. See Ch.III, *infra*, 3.3.2.2.

<sup>69</sup> This, as will be seen in chapter III, is contrary to the regime of New York Convention which provides for control both in the place of arbitration and the country of enforcement.

award losing party aware of the invalidity of the arbitration agreement will have to challenge the award in any jurisdiction where the enforcement of the award is sought.

## 2.5 Limitations of Jurisdiction

The jurisdiction of an arbitral tribunal is limited to the extent agreed upon by the parties in the arbitration agreement. A parties' freedom, however, in granting such jurisdiction is not absolute. There may be limitations imposed by the relevant laws as to what may and may not be submitted to arbitration (subject-matter arbitrability). Furthermore, limitations may exist as to the capacity of the parties to submit to arbitration. The latter is very often pleaded in the case of arbitration of state contracts. Pleas of sovereign immunity and act of state are usually raised, at the jurisdictional stage in foreign courts. Such pleas may also be raised in arbitral tribunals as limiting grounds to the jurisdiction of an arbitral tribunal.

### 2.5.1 Public Policy

Public policy or *ordre public*<sup>70</sup> is a traditional concept of private international law usually used by states to reject foreign laws or acts that contradict the states' basic principles.<sup>71</sup> Public policy can play an important role in international commercial arbitration by limiting the jurisdiction of the arbitral tribunal on grounds such as non-arbitrability of the subject-matter or incapacity of the parties, in which case the arbitral tribunal must decline jurisdiction. Public policy may also be a ground for refusal of recognition and enforcement.<sup>72</sup> A court may declare an arbitration clause covering non-arbitrable matters invalid and take jurisdiction over the claim or if there is already an award by the arbitral tribunal, the court may set it aside.<sup>73</sup>

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<sup>70</sup> Public policy and *ordre public* are often used interchangeably. Böckstiegel, K. H. Public policy and arbitrability, in *Comparative Arbitration Practice and Public Policy in Arbitration*, Edited by P. Sanders. Deventer: Kluwer 1986, 177. However, there are differences between the two concepts. See De Enterria, J. G., *The Role of Public Policy in International Commercial Arbitration*, (1989) 21 *Law and Policy in International Business* 389 at 395.

<sup>71</sup> De Enterria, *ibid.* at 390.

<sup>72</sup> E.g. Art.V(2)(b) of the New York Convention.

<sup>73</sup> E.g. Art.34(2)(b) of the Model Law.

Public policy is a relative concept depending on time and place.<sup>74</sup> What may be considered to be a public policy matter in one state may not be seen as such in another because public policy is rooted "in the economic, political, religious or social, and therefore legal system" of each country at a given time.<sup>75</sup> Values and policies change and evolve through the passage of time. Public policy adapts itself to such changes. For instance, in the context of commercial arbitration, the English concept of public policy has dramatically changed over the last three centuries.<sup>76</sup> In this context one commentator has considered public policy as a process:

"In fact, not only is a definition of public policy meaningless without reference to the setting in which it is to be applied, but the public policy exception is a judicially administered legal principle which is continually shaped by judicial interpretation. Even on a national level, public policy is more of a process than a technical concept; it does not have and cannot have a fixed content unrelated to time and circumstances."<sup>77</sup>

It is, therefore, for national laws to decide what matters are of a public policy nature. In the words of Niboyett: "nothing is more essentially national than public policy."<sup>78</sup> For reasons such as the different character of international cases and the needs of international trade, a distinction is drawn in some national laws between domestic and international public policy.<sup>79</sup> International as opposed to domestic public policy is that part of national public policy which applies to international cases. Rules of international public policy could be, as they often are, more liberal than domestic public policy.<sup>80</sup>

<sup>74</sup> Mosconi maintains that "ordre public has a relative connotation in time and in space- except for those principles which the national legal systems draw? from the international system. It is clear, in fact, that the reaction to the same external legal value can differ from one legal order to the other according to their nature which results from the specific cultural and social factors capable of affecting- as Mansini pointed out- society and individual behaviour through a circular process of interaction." Mosconi, *Exceptions to the Operation of Choice of Law Rules*, (1989) 217 RCADI 1 at 81.

<sup>75</sup> Böckstiegel, *supra*, note 69 at 179.

<sup>76</sup> See, in general, Mann, F., *Private Arbitration and Public Policy*, (1985) 4 *Civil Justice Quarterly* 257.

<sup>77</sup> De Enterría, *supra*, note 70 at 402 (footnotes omitted).

<sup>78</sup> Quoted by Dolinger, J., *World Public Policy: Real International Public Policy in the Conflict of Laws*, (1982) 17 *Texas International Law Journal* 167 at 169.

<sup>79</sup> Redfern & Hunter, *supra*, note 1 at 145-146; Böckstiegel, *supra*, note 70 at 180.

<sup>80</sup> For example, in the United States, rules concerning non-arbitrability of certain categories of disputes which are not arbitrable on domestic level are more lax as to similar disputes on international level. See (on Securities matters) *Scherk v. Alberto-Culver Co.* 417 US 506 (1974); (on antitrust disputes) *Mitsubishi Motors Corporation v. Soler Chrysler-Plymouth Inc.* 473 US 614, 105 S.Ct. 3346, 87; L.Ed.2d.444 (1985); Commentary on the US public policy see Leacock, S., *American Public Policy*, (1988) JBL 518; The distinction is expressly recognised by Art.1498 of the New French Code of Civil Procedure. Reprinted in Redfern & Hunter, *supra*, note 1, 750 at 761.

### 2.5.1.1 Transnational v. National Public Policy

Arguing the difficulties involved in the application of differing standards of public policy of each state, the case is made for the adoption of commonly-accepted standards as a basis for a 'truly' international public policy:

"Insofar as there is a regional or international community or legal system, only its common denominators in values and standards can be the basis for its eventual public policy, and they may obviously differ from those of the individual member states."<sup>81</sup>

The notion of international public policy, in this sense is thus based on a communality of values and standards emerging from more than one national legal system and hence is referred to as a 'truly international' or 'transnational' public policy.<sup>82</sup> Professor P. Lalive, one of the main advocates of this doctrine, argues two functions for transnational public policy, one negative and one positive: "It has a negative function, i.e., of exclusion, partly to be compared to that of the "exception" of public policy in traditional private international law, but it is different insofar as it may lead, not only to exclude in a given case, the laws or rules which are normally applicable by virtue of a choice of law or of an "objective" connection, but also to reject any intervention of the international public policy of a State."<sup>83</sup> The positive function of transnational public policy, he continues, "is to directly and positively influence the decision of the arbitrators, whenever fundamental and *universal notions of contractual morality* or the *fundamental interests of international trade* are involved (italics supplied)."<sup>84</sup>

In identifying substantive matters covered by such transnational public policy, Lalive mentions bribery, contractual practices facilitating drug traffic, the traffic of arms between private persons, contracts favouring kidnapping, murder, or generally the subversions or evasion of the imperative laws of a sovereign State, etc.<sup>85</sup> On the question whether "the common law of international arbitration" could "be considered as particularly imperative and having acceded to the "rank" of transnational public

<sup>81</sup> Böckstiegel, *supra*, note 70 at 180.

<sup>82</sup> Lalive, P., Transnational (or truly international) public policy and international commercial arbitration, In *Comparative Arbitration Practice and Public Policy in Arbitration*, Edited by P. Sanders. Kluwer. 261.

<sup>83</sup> *Ibid.* at 312.

<sup>84</sup> *Ibid.* at 313.

<sup>85</sup> *Ibid.* at 294; The Tribunal in *Franatome* decided certain issues on the basis of transnational public policy. (1983) VIII YBCA 107 at 109.

policy'<sup>86</sup> he finds the answer in the affirmative. Therefore, he considers arbitral awards, in this sense, to have a status even beyond national public policy and also beyond the parties' will. In the context of state contracts he maintains:

Such appears to be the case for several and perhaps all of the principles which, for instance, recognise the impossibility for a contracting State, or a State company or public organisation (a) after the execution of the contract containing an arbitration clause to invoke its incapacity to arbitrate; (b) to challenge the validity of the arbitration clause on the basis of absence of special powers to sign the contract; (c) unilaterally to rescind an international arbitration clause, either directly, or through retroactive legislation; (d) to contend that its immunity of jurisdiction entails the invalidity of the arbitration clause and thus the arbitrators' lack of jurisdiction; (e) to rely on the sovereignty of the State as a ground for the *restrictive* interpretation of the arbitration undertaking contained in an international contract.<sup>87</sup>

The idea of a 'truly international' public policy, in principle, may seem an attractive and plausible one. It has also been considered in the context of public international law.<sup>88</sup> However, there may be reservations on the way such public policy is defined, its sources and objectives.<sup>89</sup>

As mentioned, international public policy, similar to domestic public policy, as part of the national public policy of each state, is based on standards and values relative to the state interest at a given time (relativity of public policy). Such standards and values, in principle, aim to protect the interests of the public. In the context of arbitration, they are to maintain the "integrity of arbitral process" and to protect the "rights of third parties".<sup>90</sup> A State may decide to relax its rules of public policy in favour of international arbitration with respect to international transactions. However, this, as the international public policy of a state, will still be in the framework of its national policy defined by its law and implemented by its courts. If there is a conflict between the general public policy of a state on the one hand and its international public policy on the other, it should be, as it is, up to the state itself to determine how to solve the conflict. In such a case values and standards relative to the interests of the state would be taken into consideration to resolve the conflict.

<sup>86</sup> *Ibid.* at 295; for critiques of sources of international public policy see Toope, *Mixed International Arbitration: Studies in Arbitration between States and Private Persons*, Cambridge:Grotius, 137.

<sup>87</sup> Lalive, *ibid.* at 296.

<sup>88</sup> McDougal, M. and Reisman, M., International Law In Policy-Oriented Perspective, in Macdonald, R. S. J. and D. M. Johnston. *The Structure and Process of International Law: essays in legal philosophy, doctrine and theory*. The Hague/Lancaster: Nijhoff 1983, 103.

<sup>89</sup> *Ibid.* at 121.

<sup>90</sup> Park, W., *The lex loci arbitri and international commercial arbitration*, (1983) 32 ICLQ 21 at 22.

The solution would be different for an arbitrator applying 'transnational' public policy. For him, the interests of international trade would be the guiding post and not those of the state. It may be true that in some cases the interest of international trade and the interests of the state converge. However, there could be a situation where the arbitrator's understanding of public policy, inspired by standards serving the interests of the business community, would be in conflict with the state-defined public policy. On the arbitrators' role in defining transnational public policy, Mayer maintains:

Arbitrators may refuse, in the name of what they conceive to be international public policy, to apply a mandatory rule of law by reason of its content. Such a refusal posits a confrontation between the public policy of a State, namely to one having promulgated the relevant mandatory rule of law, and what one might consider to be 'arbitral' public policy. Since an arbitrator is not the guardian of the public policy of any country at all, he retains his powers of appreciation. Even if the applicability of a mandatory rule of law is perfectly evident, he may hold the rule in question to offend his conscience, and refuse to apply it... This is tantamount to a public policy defence, with the obvious difference that in the absence of a *lex fori*, the arbitrator finds the public policy in his conscience, or, as some might have it, in the fundamental tenets of a transnational *lex mercatoria*.<sup>91</sup>

In the above sense, a truly international public policy would not represent the communality of standards of international public policy of states, but personal understanding and preference of arbitrators of what could better protect and promote the interests of international trade. This notion of public policy could be highly subjective.

The doctrine of transnational public policy does not require arbitrators to decline jurisdiction upon a finding that a contract is in breach of the notion of contractual morality or contrary to the interests of international trade. It is for the arbitrator to decide that a particular contract on the above grounds is null and void and to "examine the merits and the conformity of the contract with the requirements of transnational public policy."<sup>92</sup> Therefore, the question of non-arbitrability of the subject-matter as a specific ground of public policy, which normally requires an arbitrator to decline jurisdiction, may not arise. This is contrary to the common approach of national laws on the question of arbitrability.<sup>93</sup> According to proponents of the concept of transnational public policy, the arbitrator should examine the substance of the dispute

<sup>91</sup> Mayer, P., Mandatory rules of law in international arbitration, (1986) 2 *Arbitration International* 274 at 291.

<sup>92</sup> Lalive, *supra*, note 82 at 294.

<sup>93</sup> For a detailed discussion of arbitrability see below, 2.5.2.

in any case.<sup>94</sup> This would be in conflict with the underlying rationale of and argument for public policy in private international law: that it is as a ground for reserving matters touching upon basic principles of state interests in the domain of state courts.

Transnational public policy seeks to avoid the application of those parts of national public policy which are peculiar to each country. In other words, it attempts to introduce a unified public policy. However, this runs against the very nature of public policy in private international law which, as already noted, is relative to place and time and varies from one state to another.

The introduction of 'transnational' or a 'truly international public policy' is a necessary ingredient for the delocalisation or transnationalisation of the arbitral process.<sup>95</sup> Its function is to eliminate the controlling role of national public policy over the arbitral procedure and award. A transnational model of arbitration, discussed later in this work, is based on the assumed existence of a third legal order- transnational law merchant in which states play no role. The international arbitrator, in this legal order, is a law maker as well as arbiter.<sup>96</sup> The policy followed by the international arbitrator in his law-making capacity is transnational public policy which, by its nature, is a kind of international commercial policy. Transnational law of merchant is a policy-oriented law- the policy followed is transnational public policy which is to serve the interests of the international business community. It is in this sense that transnational public policy assumes a 'positive' role. As will be seen in further parts of this work, such concepts as a third legal order and <sup>transnational</sup> arbitration do not correspond to the realities of our world and that of international community processes.

Despite the claims for the existence of a transnational public policy, it should be noted that it is the state where the arbitration is held and the state where recognition and enforcement of the award is sought which have the power to define the public policy rules and not the arbitral tribunal.<sup>97</sup> The idea of a transnational public policy has not

<sup>94</sup> *Ibid.*; also Lew, J., Determination of arbitrator's jurisdiction and the public policy limitations on that jurisdiction, in *Contemporary Problems in International Arbitration*, edited by J. Lew, London: Commercial Law Centre, Queen Mary College 1986, 73.

<sup>95</sup> The question of the delocalisation of the arbitral process in general is covered in Chapters III.

<sup>96</sup> For the discussion of law making by transnational arbitration see Ch. VII, *infra*.

<sup>97</sup> Sever, J., the relaxation of inarbitrability and public policy checks on US and foreign arbitration: arbitration out of control?, (1991) 65 *Tulane Law Review* 1661 at 1690.

attracted much support from national laws and national courts.<sup>98</sup> Therefore, as long as states reserve certain areas for exclusive jurisdiction of their courts, no arbitral tribunal can validly take jurisdiction over such subject-matter within the territory of that state. Furthermore, no arbitral award could be enforced as long as it is contrary to the public policy of the place where the enforcement is sought.<sup>99</sup>

### 2.5.2 Subject- Matter Arbitrability

An arbitral tribunal's jurisdiction extends as far as agreed upon by the parties to the arbitration agreement. However, the parties' freedom in setting the scope of the arbitrators' jurisdiction is not unlimited. One limitation to the 'party autonomy' rule in this respect is lack of arbitrability when, in the language of the New York Convention, the subject matter is not "capable of settlement by arbitration".<sup>100</sup> The notion of arbitrability is one of public policy. Each state decides for itself according to its national interests what kinds of disputes are arbitrable and what areas due to their importance are kept for national courts.<sup>101</sup> Due to the similarity of the defences of public policy and arbitrability proper, and also their nature and origin, the two notions are sometimes used interchangeably. However, the distinction has been adopted by the New York Convention and the Model Law.<sup>102</sup>

The issue of arbitrability can be relevant in the place of arbitration and where recognition and enforcement of the award is sought. For example, in the context of the New York Convention, a party may challenge the arbitration agreement on the ground that under the national law of the place of arbitration, the dispute is not capable of

<sup>98</sup>The notion of truly international public policy was rejected by the Austrian Supreme Court (*Obster Gerichtshof*) in Decision of May 11, 1985 (1985) 10 YBCA 421; See also the ICC final award in case 5622, 1988 where the tribunal relied on Swiss public policy to dismiss a claim based on a contract concerning traffic of influence. (1994) XIX YBCA 705. However, in *Valenciana*, the French court of cassation endorsed the notion of a truly international public policy. Decision of Paris Court of Appeals, 13 July 1989, reported in (1991) XVI YBCA 137; confirmed by cour de cassation, 22 October 1991, reported in (1993) XVIII YBCA, ? ; commentary in Ancel, J. P., *French Judicial Attitudes Towards International Arbitration*, (1993) 9 *Arbitration International*, 121.

<sup>99</sup>See *Northrop v. Triad Financial Establishment*, 593 Supp. 928 (1984) where the court refused recognition and enforcement of an award rendered for payment of commissions which constituted bribes according to the relevant laws - Saudi and US laws.

<sup>100</sup>Art. II (1).

<sup>101</sup>Redfern and Hunter, *supra*, note 1 at 137.

<sup>102</sup>Art.V(2)(a) and (2)(b) of the New York Convention.

settlement by arbitration.<sup>103</sup> Art.V.(2)(a) of the Convention provides a ground for refusal of recognition and enforcement of an award when the court of the place where recognition and enforcement is sought finds that “the subject-matter of the dispute is not capable of settlement by arbitration under the law of that country”.

Therefore, the laws of the place of arbitration and those of the place where recognition and enforcement of the award is sought are interested in formulating and defining limits of arbitrability which are in a sense limits to party autonomy with regard to the jurisdiction of an arbitral tribunal. Furthermore, the governing law of the arbitration agreement itself has to be taken into account.<sup>104</sup> Therefore, there could be at least three relevant laws in relation to the question of arbitrability.<sup>105</sup>

Due to their sensitivity, resolution of disputes relating to certain areas, are reserved within the exclusive jurisdiction of national courts. It is up to each state to determine which disputes are arbitrable and which are not. Market economy countries, where the major bulk of economic activities are conducted by private businesses, adopt the most liberal approach to the question of arbitrability. This approach is especially directed towards international arbitration as distinguished from domestic arbitration. Therefore, in recent years, a trend has been emerging towards widening the scope of arbitrable disputes which are submitted to international commercial arbitration.<sup>106</sup>

In countries where states play a more active role in the conduct of the economy, be it in foreign trade or investment, the tendency is to try to have the resolution of disputes arising from such legal relationships within the exclusive jurisdiction of national courts; there are more likely to be some restrictions or prohibitions on arbitration.<sup>107</sup> With the changing economic systems of the former socialist countries of Eastern Europe and their adoption of market economy principles it is expected that new

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<sup>103</sup> Art. II (1).

<sup>104</sup> Art. V(2) of the New York Convention.

<sup>105</sup> Böckstiegel observes: Objective arbitrability is considered to be subject to the law found applicable either to the arbitration agreement, or to the subject-matter, or to the main contract, or to both, or to the procedure of arbitration, or to the subject-matter in question.” Böckstiegel, *supra*, note 70 at 184.

<sup>106</sup> For example the US Courts have increasingly allowed kinds of disputes which traditionally were in exclusive domain of courts to be resolved in arbitration. See O'Neill, *The recognition and Enforcement of Foreign Arbitral Awards in the United States: Defences of Arbitrability*, (1986) 37 *South Carolina Law Review* 719.

<sup>107</sup> See Ch.I, *supra*, 1.3.4.

legislation and the changing practices of these countries will also result in a widening of the scope of the matters settled by arbitration.

There are areas recognised by national laws to be non-arbitrable such as antitrust or competition, intellectual property, securities transactions, bankruptcy, exchange control, bribery and fraud. The scope of the arbitrability is not a fixed one. National legislation and court decisions, as will be seen below, may from time to time redefine it.<sup>108</sup>

Antitrust and competition disputes traditionally have been considered by national laws as not being capable of settlement by arbitration. This is due to the public interest element involved and the complexity of the issues raised. For example, US law traditionally followed a restrictive approach not allowing arbitration of antitrust issues.<sup>109</sup> However, the majority of the Supreme Court in the *Mitsubishi* case made a distinction between domestic and international antitrust cases and decided that in the interests of “international comity, respect for the capacities of foreign and transnational tribunals, and sensitivity to the need of the international commercial system for predictability in the resolution of disputes” international antitrust cases were arbitrable.<sup>110</sup> Contrary to the position under US law, in member States of the European Union (EU), an arbitrator may not be empowered to decide on agreements which are allegedly in violation of EU competition laws.<sup>111</sup> Therefore, an arbitrator may not rule on whether an agreement is exempt from the competition rules of the EU under Art.85(3) of the Treaty of Rome.<sup>112</sup> Intellectual property, bankruptcy and matrimonial disputes form some other categories of disputes which according to many national laws are non-arbitrable.<sup>113</sup> The rationale behind this policy is the involvement of the state’s interests and the presence of third party rights in such disputes. Another,

<sup>108</sup> See, for example, the English law position on arbitrability in Mustil, R. , and Boyd, *The law and practice of commercial arbitration in England*. 2nd ed. London: Butterworths 1989.

<sup>109</sup> *American Safety Equipment Corp. v. J. P. Maguire & Co.* 391 F.2d 821 (2d Cir. 1968)

<sup>110</sup> *Mitsubishi Motor Corp. v. Soler Chrysler-Plymouth Inc.*, 473 US 614, 105 S.Ct.3346, 87: L.Ed. 2d.444 (1985)

<sup>111</sup> Art. 85 of Treaty of Rome.

<sup>112</sup> According to Reg.17/1962 this is within the exclusive jurisdiction of the EC Commission; for critiques of this view see Jarvin, S., The sources and limits of the arbitrator’s powers, in *Contemporary Problems in International Arbitration*, edited by J. Lew, 50 at 69-70.

<sup>113</sup> Redfern and Hunter, *supra*, note 1 at 138-42.

category of disputes which are claimed to be within the exclusive jurisdiction of national courts are those relating to the regulation of foreign trade and exchange transactions.<sup>114</sup> On security transactions, the US courts have made a distinction between domestic and international contracts and have adopted a liberal approach towards the latter by allowing arbitration of disputes arising out of such contracts.<sup>115</sup>

An allegation of fraud or bribery is argued to be a ground for non-arbitrability of a dispute. Therefore, an arbitrator faced with an allegation of this nature should decline jurisdiction and leave the matter to be decided by a competent court.<sup>116</sup> More recently, however, an arbitral tribunal chose to consider the case on its merits despite allegations of fraud and bribery.<sup>117</sup> In that case the tribunal decided the question of arbitrability on the basis of 'transnational public policy'. The decision has been criticised on the ground that an arbitral tribunal does not have at its disposal the machinery to investigate the occurrence of bribery involving officials of states.<sup>118</sup> So "[T]he state should have priority on pronouncing on whether its officials were fraudulent or not."<sup>119</sup> It should be borne in mind that the question of arbitrability is basically one for the relevant applicable laws since generally an award issued in violation of such laws with respect to the question of arbitrability may not be enforced.<sup>120</sup>

In the context of state contracts, the issue is whether there may be any role for the law of the state party in relation to the question of arbitrability. The subject matter of the dispute should be arbitrable according to the applicable law of the contract. It is noted that "[F]rom the point of view of the arbitrability of disputes referred to *ad hoc* tribunals or institutional tribunals which do not owe their existence to any international treaty, the issue has always to be decided in accordance with domestic system of law... The contract can only have a basis in municipal systems which should provide the rule

<sup>114</sup> Böckstiegel, *supra*, note 70 at 199.

<sup>115</sup> *Scherk v. Alberto-Culver co.* 417 US 506 (1974).

<sup>116</sup> See the case decided by Lagergren cited in Redfern & Hunter, *supra*, note 1 at 145 footnotes omitted

<sup>117</sup> *Framatome v. Atomic Energy Organisation of Iran* (1983) VIII YBCA 107.

<sup>118</sup> Sornarajah, *International Commercial Arbitration*, Singapore: Longman 1990, at 171-2.

<sup>119</sup> *Ibid.*

<sup>120</sup> For example, under the New York Convention non-arbitrability of the subject-matter of the dispute is a ground for refusal of recognition and enforcement of the award.

according to which the issue of arbitrability should be decided.<sup>121</sup> If, in order to determine the applicable law, a conflict-of-law method is applied, there will be a good chance that the law of the state party would be determined as the applicable law in which case there will be a role for that law in relation to the question of arbitrability of the disputes and limitations thereto.<sup>122</sup> Furthermore, even in cases where the applicable law is not the law of the state party, the mandatory law of the state may be relevant as the applicability of mandatory rules does not necessarily depend on such rules being part of the *lex contractus* or the *lex fori*. According to the prevailing view, there could be situations where effects should be given by arbitral tribunals to mandatory rules of laws foreign to the *lex contractus* and to the other relevant laws on arbitrability.<sup>123</sup> In such a case, if the dispute involves vital national interests, the arbitrator should decline jurisdiction since such issues are not arbitrable according to the relevant mandatory laws. Based on a public interest requirement, a state may change its law which could affect the arbitrability of its contractual disputes.<sup>124</sup> However, as will be seen later in this work, in order to insulate the contract from the application of the law of the state party, alternative methods of determination of applicable law have been advanced by the supporters of internationalisation of international commercial contracts and arbitration.<sup>125</sup> As a result of the application of such methods, determinations of arbitration on applicable law would be free from the intervention of otherwise relevant public policies. This could result in a lesser role, if any, for the state law on the question of arbitrability.<sup>126</sup> However, it has been admitted even by the proponents of transnational arbitration national public policies still play an important role in arbitration:

Notwithstanding the governing influence of transnational principles in international arbitration and the increasing harmonisation of international arbitration law and practice, national laws and

<sup>121</sup> Sornarajah, *supra*, note 118 at 168.

<sup>122</sup> See chapter IV at 129.

<sup>123</sup> Hochstrasser in his study of the topic arrives at the conclusion that the prevailing view among authors is that in certain circumstances "an arbitral tribunal should take into account and apply mandatory provisions from the country other than the one chosen by the parties". Hochstrasser, D., Choice of Law and "Foreign" Mandatory Rules in International Arbitration, (1994) 11 J.Int.Arb. 54 at 85; On the relevance of mandatory rules of law in arbitration see Lazareff, S., Mandatory Extraterritorial Application of National Law, (1995) 11(2) Arb.Int. 137.

<sup>124</sup> *Ibid.*

<sup>125</sup> See chapter IV, *infra*, 4.3.

<sup>126</sup> *Ibid.*

concepts of public policy continue to be of great practical importance when it comes to assessing such matters as arbitrability and the efficacy of arbitral awards, which are subject to control by national courts.<sup>127</sup>

In the case of the Iran-US Claims Tribunal and ICSID arbitrations the question of arbitrability was decided within the framework of an international treaty or convention, so that a claim of lack of arbitrability of a dispute before such tribunals has to be substantiated against the provisions of such instruments and not national laws.<sup>128</sup>

### 2.5.3 Lack of Capacity

Some municipal laws impose restrictions on the power of the state or its entities to submit to arbitration. Since such restrictions could affect the validity, and indeed the existence, of an arbitration agreement they can be regarded as limitations to the jurisdiction of arbitral tribunals; they are thus referred to as limitations of subjective arbitrability.<sup>129</sup>

The scope of such limitations on the capacity of a state or its entities to submit to arbitration varies in different countries. Saudi law imposes a general prohibition on the State and its agencies to submit to arbitration with the exception of arbitration allowed by the Council of Ministers.<sup>130</sup> Similarly, under Spanish law, the State and its agencies may not submit to arbitration unless authorised by decree.<sup>131</sup> In some countries, a distinction is made between public entities which are more likely to be subject to restriction on entering into arbitration agreements and the private law companies of the state which may not be subject to such restrictions, or at least not to the same extent.<sup>132</sup> Such a distinction is more common among the industrialised countries of Western Europe. In Germany, for instance, the State and state entities are permitted to agree to

<sup>127</sup> Schwartz, E. A., *The Domain of Arbitration and Issues of Arbitrability: The View from the ICC*, (1994) ICSID Rev.-FILJ 17 at 46.

<sup>128</sup> See Art.II(1) of the Iran-United States Claims Settlement Agreement; also Art.25 of the ICSID Convention.

<sup>129</sup> "... regulating what is commonly understood as "capacity" is in fact a regulation of arbitrability by subjective criteria, namely by criteria connected with the parties in arbitration." Böckstiegel, *supra*, note 70 at 181.

<sup>130</sup> Van den Berg, A., National Report on Arbitration: Saudi Arabia, *Handbook Commercial Arbitration*, *supra*, note 3 at 9-10.

<sup>131</sup> Cremades, B., National Report on Arbitration: Spain, *ibid.* at 5.

<sup>132</sup> Böckstiegel, K. H., *Arbitration and state enterprises: a survey on the national and international state of law and practice*, Deventer: Kluwer 1984, 15.

arbitration with regard to legal relationships governed by private law. As for the agencies of the Federal Government and of the *Lander*, they must first obtain the approval of the Ministry of Finance.<sup>133</sup>

There are no restrictions in India<sup>134</sup> and Denmark<sup>135</sup> for states to submit to arbitration. Submission to arbitration is permitted ( and in some cases is mandatory) by law in the member states of the CMEA.<sup>136</sup> Disputes between the economic organisations of different member countries of the CMEA arising in connection with economic and scientific-technical co-operation should be submitted to arbitration.<sup>137</sup>

Conflict-of-law rules generally refer the question of the capacity of parties in a contract to their respective law which, for state parties in a contract, would be the law of the state and for the public entity the law of the place of incorporation or its seat.<sup>138</sup> This view has also been adopted by the New York Convention and a number of arbitral awards.<sup>139</sup> In *Societe des Grands Travaux de Marseille v. People's Republic of Pakistan*, on the question of the legal capacity of state entities, the Federal Supreme Court of Switzerland held that "all problems concerning the legal status of a legal entity are governed by the law of the state in which it has its seat (*siege*) and from which it derives its legal capacity. The same law is applicable if the legal entity is a legal entity of public law."<sup>140</sup> The Court rejected the argument that the government orders to dissolve its entity were aimed at evading its obligations, including those in relation to an arbitration agreement, and therefore were discriminatory, and contrary to *ordre public* of the forum.<sup>141</sup> The Court did not find a territorial connection, a jurisdictional requirement of Swiss law, between the case and the forum to consider the public

<sup>133</sup> Glossner, National Report on Arbitration: F.R.Germany, in *Handbook Commercial Arbitration*, *supra*, note 3 at 6.

<sup>134</sup> Krishnamurathi, N., National Report on Arbitration: India, *ibid.* at 4.

<sup>135</sup> Philip, A., National Report on Arbitration: Denmark. *ibid.*

<sup>136</sup> See in general Strohbach, *supra*, note 3.

<sup>137</sup> *Ibid.* at 5-6.

<sup>138</sup> Lalive, Transnational (or truly international) public policy, *supra*, note 82 at 296.

<sup>139</sup> Art.V(1)(a) considers incapacity of the parties to the arbitration agreement, *under the law applicable to them*, as a ground to refusal of recognition and enforcement; The Tribunal in *LIAMCO* also looked at the matter under the personal law of the parties. *Libyan American Oil Company (LIAMCO) v. The Libyan Arab Republic*, Award of 12 April 1977, 62 ILR 141 at 176-179.

<sup>140</sup> The Federal Supreme Court, 5 May 1976, V YBCA (1980) 217 at 218.

<sup>141</sup> *Ibid.*

policy argument.<sup>142</sup> In another case, the umpire accepted an argument that the state party was under some kind of incapacity according to its law introduced even *after* the conclusion of the arbitration agreement.<sup>143</sup> This case has been criticised for allowing states to evade their obligation to arbitrate simply by relying on the restrictions contained in their national laws.<sup>144</sup> This would be an easy way to escape arbitration by enacting new laws prohibiting public entities from submitting to arbitration. Here the principle of applicability of personal law to the matter of capacity to contract would stand against the principle of good faith.<sup>145</sup>

To remedy this situation, it has been suggested that, following the example of French law, restrictions applicable to domestic arbitration should not be relevant in international commercial arbitration.<sup>146</sup> In France, states and their public entities were traditionally barred from concluding arbitration agreements. However, this practice changed to some extent following the decision of the Court of Cassation in *Galakis*.<sup>147</sup> It was argued in that case that on the basis of the rule prohibiting the Government and its entities to conclude arbitration agreements the arbitration agreement of the charterparty in dispute was not valid. The Court, rejecting this argument, made a distinction between domestic and international arbitration and held that the prohibition rule applied only to domestic arbitrations and not to international arbitrations.<sup>148</sup> The distinction has been maintained in France after the introduction of the new provisions on arbitration to the French Code of Civil Procedure.<sup>149</sup>

Therefore a distinction is made between an undertaking of a state or a state entity at

<sup>142</sup> *Ibid.* at 218-19.

<sup>143</sup> *Losinger Award of the Umpire Henri Thelin*, 30 October 1935, PCIJ Ser. C. No. 78 at 105 et seq.; In contrast, see the decision of the Tribunal in *Framatome* (1983) VIII YBCA 107.

<sup>144</sup> Paulsson, J., May a State invoke its internal law to repudiate consent to international commercial arbitration? Reflections on the *Bentler v. Belgium*, Preliminary Award, (1986) 2 *Arbitration International* 90; Lalive, P. Arbitration with foreign states or state-controlled entities: some practical questions, in *Contemporary Problems in International Arbitration*, at 289.

<sup>145</sup> Audit, *Transnational Arbitration and State Contracts: Finding and Prospects*, Deventer: Kluwer 1988, at 93-97.

<sup>146</sup> Batifol, Arbitration Clauses Concluded between French Government-Owned Enterprises and Foreign Private Parties, (1968) 7 *Columbia Journal of Transnational Law* 32.

<sup>147</sup> *Tresor Public v. Galakis*, 2 May 1966, (1966) *Clunet* 648; summary and commentary in Batifol, *ibid.*

<sup>148</sup> *Ibid.* at 34.

<sup>149</sup> Craig, W.L., Park, W and Paulsson, J., French codification of a Legal Framework for International Arbitration, (1981) 13 *Law and Policy in International Business* 727 at 738.

the national and international levels. The question of incapacity at the international level, as opposed to the situation in domestic arbitration, it is suggested, should not be tested exclusively against the personal law of the entity. It is also to be tested against other principles such as fundamental principles of 'good faith'<sup>150</sup>, 'transnational public policy',<sup>151</sup> 'non venire contra factum proprium', abuse of rights, and estoppel<sup>152</sup> so that the possibility of abuse by a state or state party of legal forms, entirely at its control, is eliminated.

The Swiss legislature has explicitly addressed the question of applicable law to the capacity of the state in relation to arbitration. It has eroded the possibility of a claim of incapacity, under its law, by a state party to an arbitration agreement:

"If a party to the arbitration agreement is a state or an enterprise held, or an organisation controlled by it, it cannot rely on its own law in order to contest its capacity to be a party to an arbitration or the arbitrability of a dispute covered by the arbitration agreement."<sup>153</sup>

There have been a number of arbitral awards which have considered the issue and decided not to apply the law of the state to the question of capacity. The *Bentler* case involved a dispute between German private parties and the State of Belgium in connection with a contract containing an arbitration clause signed by two Belgian ministers by which the two German parties became shareholders in a Belgian company.<sup>154</sup> The dispute involved the question of the validity of the submission by the State of Belgium to the jurisdiction of an international arbitral tribunal. Belgian law contains a restriction prohibiting public law entities from concluding arbitration agreements. The State itself could conclude arbitration agreements under the authorisation of a treaty.<sup>155</sup> In the course of the arbitration, Belgium argued that the permission to conclude arbitration agreement was only to arbitration concluded under

<sup>150</sup>Paulsson, *May a State*, *supra*, note 144 at 90.

<sup>151</sup>Lalive, *Transnational Public Policy*, *supra*, note 80 at 297; also see *ICC Case No. 1939* where it was held by the arbitral tribunal: "... international *ordre public* would vigorously reject the proposition that a State organ, dealing with foreigners, having openly, with knowledge and intent concluded an arbitration clause that inspires the concontractant's confidence, could thereafter, whether in the arbitration or in execution proceedings, invoke nullity of its own promise." Paulsson, *ibid.*

<sup>152</sup>Böckstiegel, *States in International Arbitral Process*, In *Contemporary Problems in International Arbitration*, Edited by J. Lew, London: Kluwer 1986, at 203.

<sup>153</sup>Art. 177(2) Swiss Private International Law Act 1987, translation in English in Redfern & Hunter, *supra*, note 1 at 784.

<sup>154</sup>[1985] European Commercial Cases 101.

<sup>155</sup>Art. 1672 (2) of the Belgian *Code Judiciaire*.

a treaty provision and therefore was not applicable to this case. The Tribunal, however, decided that it had jurisdiction by virtue of the provisions of the European Convention on International Commercial Arbitration which is applicable to 'disputes arising from international trade between physical or legal persons having, ..., their habitual place of residence or their seat in different Contracting States.'<sup>156</sup> Art.II(1) of the Convention provides that 'legal persons of public law have the right to conclude valid arbitration agreements.' The Tribunal considered that an international treaty takes precedence over internal law and therefore the State of Belgium did have capacity to conclude the arbitration agreement and that the Tribunal had jurisdiction. This award has been used to support the argument that, the interest of international trade and the common law of arbitration requires a claim by a state of incapacity, should be rejected.<sup>157</sup> However, it is submitted that the Tribunal's decision on the issue was consistent with the law of the state party i.e. the Belgian law. It can be justified entirely within the framework of Belgian law including its treaty obligations which allowed the State of Belgium to become a party to an international arbitration.

In a more recent case, the Tunisian Government unilaterally terminated a contract with a French contractor which provided for arbitration.<sup>158</sup> The Government refused to appoint its arbitrator arguing the invalidity of the arbitration agreement since public authorities, as a matter of principle, were not empowered to agree arbitration clauses. The Tunisian Court interfered by appointing an arbitrator and therefore enforced the arbitration agreement.

In addition to the question of the capacity to submit to arbitration, in relation to the jurisdiction of an arbitral tribunal, the authority of the official who conclude the arbitration agreement may give rise to some problems.<sup>159</sup> In the *Framatome* arbitration, the AEIOI challenged the jurisdiction of the ICC tribunal arguing among other things the nullity of the contract and arbitration clause on the ground of incapacity of the state

<sup>156</sup> Art.I(1)(a) of the European Convention on International Commercial Arbitration (the Geneva Convention), April 21, 1961 UNTS (1963-64) Vol. 484, 364.

<sup>157</sup> Paulsson, May a State invoke, *supra*, note 144 at 96-98.

<sup>158</sup> Court of first instance of Tunis and Court of Appeal of Tunis XV YBCA (1990) 518.

<sup>159</sup> Lalive, P., Arbitration with foreign States or state-controlled entities: some practical questions. In *Contemporary problems in international arbitration*, *supra*, note 159, at 289.; Delaume, G., *Law and Practice of Transnational Contracts*, New York: Oceana 1988 at 363-372.

party according to the new Iranian Constitution and lack of authorisation of the President of the AEOI to conclude the contract.<sup>160</sup> The tribunal agreed with the Iranian side that there were irregularities involved in the conclusion of the contract which should have been avoided by *both* parties. The Tribunal, however, held that the AEOI could not rely on such irregularities as a ground for the invalidity of the contract, as it had been ratified by the conduct of the parties including the AEOI officers.<sup>161</sup> The Tribunal, furthermore, considered it contrary to *international public policy*, as appertaining to international commercial usages or recognised principles of public international law and the law of international arbitration or *lex mercatoria*, to allow a state to repudiate the undertaking to arbitrate.<sup>162</sup>

In the *Pyramids* case, the Egyptian Minister of Tourism had signed an agreement containing an arbitration clause providing for ICC arbitration and had added 'approved, agreed and ratified'.<sup>163</sup> The parties to the agreement were Southern Pacific Properties (SPP) and the Egyptian Tourism Organisation (EGOTA). In an arbitration relating to the case, the Tribunal did not accept the Government's claim that it was not a party to the agreement and that the Minister's signature was given merely in the exercise of his supervisory power. An award was rendered in Paris. The Government challenged the award in the Court of Appeal of Paris on the grounds that it was not a party to the ICC arbitration clause and that it had not waived its immunity from jurisdiction.<sup>164</sup> The court accepted this argument and added that the "approval" given should be interpreted according to the Egyptian law.<sup>165</sup>

It would appear that, on the question of the capacity of the state to submit to arbitration, in principle, the law of the state party is applicable. However, in the interests of effective international commercial arbitration, some national laws and arbitral tribunals have decided the matter on the basis of international public policy.

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<sup>160</sup> *Franatome Award*, (1983) VIII YBCA 107.

<sup>161</sup> *Ibid.*

<sup>162</sup> *Ibid.* at 109.

<sup>163</sup> Award of February 16, 1983, (1983) 22 ILM 752

<sup>164</sup> *Arab Republic of Egypt v. Southern Pacific Properties*, 12 July 1984, Decision of the Paris Court of Appeals, (1985) X YBCA 113 and *cour de cassation* (1988) XIII YBCA 152.

<sup>165</sup> *Ibid.*

### 2.5.4 Sovereign Immunity

According to this doctrine courts do not take jurisdiction over a foreign State.<sup>166</sup> This is based on the principles of equality of States in international law and international comity.<sup>167</sup> "Legal persons of equal standing cannot have their disputes settled in the courts of one of them."<sup>168</sup> The immunity is granted to prevent the situation "where one State by reason of its control of the litigation and courts of the legal system operating in its territory has an unfair advantage over a foreign state which appears as a litigant in its courts."<sup>169</sup>

"One sovereign being in no respect amenable to another; and being bound by obligations of the highest character not to degrade the dignity of his nation, by placing himself or his sovereign rights within the jurisdiction of another, can be supposed to enter a foreign territory only under an express license, or in the confidence that the immunities belonging to his independent sovereign station, though not expressly stipulated, are reserved by implication, and will be extended to him."<sup>170</sup>

Therefore, settlement of claims against States, generally, will be left to the executive branch of the government. Traditionally, the doctrine covered all types of claims and the immunity granted was absolute.<sup>171</sup> However, the increasing level of participation of states and their instrumentalities in commercial transactions with foreign private parties was a ground for the introduction of the restrictive theory of sovereign immunity.<sup>172</sup>

According to the restrictive theory, the immunity of a sovereign is recognised only in relation to its acts of sovereignty (*jure imperii*) and not to its private acts (*jure*

<sup>166</sup> See in general Brownlie, I., *Principles of Public International Law*, Oxford: Clarendon Press 1990, Ch. XV; Trooboff, P. D., Foreign sovereign immunity: Emerging consensus of principles, (1986) RCADI 245-429; Sinclair, L. I., The law of sovereign immunity: recent developments, (1980) 167 RCADI 113-284; Oparil, R., Waiver of Sovereign Immunity in the United States and Great Britain by an arbitration agreement, (1985) 2 J. of Int. Arb., 61; Sornarajah, M., Problems in applying the restrictive theory of sovereign immunity, (1982) 31 ICLQ 661-685; Sullivan, G. B., Implicit waiver of sovereign immunity by consent to arbitration: Territorial scope and procedural limits, [*MINE v Republic of Guinea*], (1983) 18 Texas International Law Journal 329-345; Fox, H., Sovereign immunity and arbitration, In *Contemporary problems in international arbitration*, edited by J. Lew, London: Kluwer 1986, 323.

<sup>167</sup> Brownlie, *ibid.* at 325.

<sup>168</sup> *Ibid.*

<sup>169</sup> Fox, H., Sovereign immunity and arbitration, *supra*, note 163 at 323.

<sup>170</sup> *The Schooner Exchange v. McFadden*, 11 U.S. (7 Cranch) 116, 3 L.ED. 287; reproduced in Harris, D. J., *Cases and Materials on International Law*, London: Sweet and Maxwell 1983, at 242

<sup>171</sup> *The Porto Alexander case*, [1920] at 30 (UK); *Berizzi Bros. v. The Steamship Pesaro* 271 US 562 (1926).

<sup>172</sup> In England the shift towards the restrictive theory could be seen in *The Philippines Admiral* [1977] AC 373; ; *Trendex Trading Corp. v. Central Bank of Nigeria*, [1977] Q.B. 529 where it was held by Lord Denning that there will be no sovereign immunity in a straightforward case involving a purely commercial transaction; also *Alcom Ltd. v. Republic of Columbia* [1984] 1 AC 580, 584.

*gestionis*). This distinction has been adopted by many countries which have enacted modern legislation on sovereign immunity such as UK<sup>173</sup> and US.<sup>174</sup> However, there is no fully consistent practice among states.<sup>175</sup> It is this state of affairs which gives rise to disagreement as to the existence of a rule of customary law reflective of the restrictive theory of sovereign immunity. However, a trend is seen in favour of this theory.<sup>176</sup>

In defining the modalities of the doctrine two tests of the nature and the propose of the state's act are employed. The ILC Draft Articles consider the application of a nature test potentially detrimental to the interests of the developing states; they are in favour of a "two-pronged approach, which provides for the consideration not only of the nature, but in some instances also of the purpose of the contract or transaction, which give enough protection to the interest of the developing states."<sup>177</sup> It is suggested that the favourable solution would be to make a list of acts which would not be immune.<sup>178</sup>

Section 1605(a)(2) of the U.S. Foreign Sovereign Immunities Act (FSIA) provides that a foreign State shall not enjoy jurisdictional immunity in any action "which is based upon a "commercial activity"<sup>179</sup> According to section 1603(d) "[A] commercial

<sup>173</sup> In England, traditionally, the rule of absolute immunity applied. *Parlement Belge* case (1880) 5PD 197; in *Porto Alexander* [1920] P.30; immunity was granted to state trading vessels. Division of opinion in courts started to appear in *Cristina* case [1938] AC 485 and *Karjina v. Tass Agency* [1949] 2 All E.R. 274. The influence of the restrictive theory started to appear in *Philippine Admiral* [1977] AC 373 where state trading vessels were denied immunity; in *Thai-Europe Topioca Service v. Government of Pakistan* [1975] 1 WLR 1485 a distinction was made between action in rem and action in personam with respect to the question of immunity. In *Trendtex Trading Corporation Ltd. v. Central Bank of Nigeria* [1977] 2 WLR 356 all judges of Court of Appeal adhered to the restrictive theory of immunity. The doctrine was adopted by the 1978 State Immunity Act and was reaffirmed in *I Congreso del Partido* [1981] 2 All ER 1064 and *Alcom Ltd. v. Republic of Columbia* [1984] 2 WLR 750 (HL). For the recent treatment of the doctrine of restrictive immunity see *Kuwait Airways Corporation v. Iraqi Airways Co.* [1995] 1 WLR 1147.

<sup>174</sup> Rule of absolute immunity was upheld in *Berizzi Bros. v. The Steamship Pesaro* 271 US 562 (1926). By the Tate letter of 1952, the United State Department of State declared in the view of increasing involvement of activities of states in commercial activities together with the changing attitudes of foreign laws on absolute immunity the Department would follow the restrictive theory of immunity. 26 Department of State Bulletin, 984 (1952) The restrictive theory was also adopted by US courts. See *Victory Transport Inc. v. Comisaria General de Abastecimientos y Transportes*, 35 ILR 110. The 1976 FSIA has also adopted the restrictive theory of immunity.

<sup>175</sup> Brownlie, *supra*, note 166 at 330.

<sup>176</sup> The ILC Draft Articles and new legislations on Sovereign immunity have embraced the restrictive theory of immunity. See The State Immunity Ordinance of 1981 of Pakistan, section 5, text reproduced in the *United Nations Materials on Jurisdictional Immunities of States and their property*, UN Publication, Sales No.E/F.81.V.10 at 21-22, Singapore State Immunity Act of 1979, section 5, *ibid.* at 29, Australian Foreign States Immunities Act of 1981, (1986) 25 ILM 715.

<sup>177</sup> The 1992 International Law Commission Draft Articles on Jurisdictional Immunities of States and Their Property (typescript).

<sup>178</sup> Sornarajah, Problems in applying the restrictive theory, *supra*, note 166 at 669-70.

<sup>179</sup> USC, Title 28, reproduced in 63 ILR 655.

activity means either a regular course of commercial or a particular commercial transaction or act. The commercial character of an activity shall be determined by reference to the *nature* of the course of conduct or particular transaction or act, rather than by reference to its *purpose* (italics supplied)."

A similar provision can be found in Section 3 of the U.K. State Immunity Act (SIA) which relates to commercial transactions and contractual obligations which are wholly or partly performed in the United Kingdom.<sup>180</sup> The Act includes a list of activities which fall under the term "commercial transactions".<sup>181</sup> In the former socialist countries, the position was different. For example, in the former USSR, the restrictive theory of immunity was rejected as there could be no distinction between "acts of a Socialist State which are of public nature and acts which are of a private or commercial nature."<sup>182</sup> However, in practice, the Soviet State concluded bilateral treaties according to which it agreed to submit to the jurisdiction of local courts in respect to certain specified areas including foreign trade and investment.<sup>183</sup> As far as international arbitral proceedings were concerned, the restrictive theory of immunity to the extent of jurisdiction, and not as to provisional measures and enforcement proceedings, was accepted by the Soviet State.<sup>184</sup> It is not yet clear to what extent the changes in the politico-economic system of the ex-socialist states have influenced their view of sovereign immunity.

#### 2.5.4.1 Sovereign Immunity and Arbitration

In the context of the jurisdiction of arbitral tribunals it is said that an agreement by a state to arbitration is usually considered as an implicit waiver of sovereign immunity.<sup>185</sup>

In the context of state immunity and arbitration, a distinction should be made between the jurisdiction of courts in proceedings related to arbitration on the one hand and the

<sup>180</sup> Reproduced in Harris, *supra*, note 170 at 247.

<sup>181</sup> *Ibid.*

<sup>182</sup> Osakwe, C., A Soviet perspective on foreign sovereign immunity: law and practice, (1983) 23 *Va.J.Int.L.L.* 13 at 14.

<sup>183</sup> Shaw, *International Law*, 3rd edition, Cambridge: Grotius 1991, at 440. E.g. see the Agreement between the USSR and France in UNTS vol.221, 95.

<sup>184</sup> Osakwe, *supra*, note 182 at 15.

<sup>185</sup> Oparil, *supra*, note 166 at 67; Wetter, Pleas of Sovereign Immunity and Act of Sovereignty before International Arbitral Tribunals, (1985) 2 *J. Int. Arb.* 7 at 14.

jurisdiction of the designated arbitral tribunal on the other. Sovereign immunity, as noted above, may be considered as a bar to the jurisdiction of courts because due to the equality of states a court of one state cannot take jurisdiction over another state. In arbitration, the state party freely chooses to submit to the jurisdiction of an arbitral tribunal; it is the consent of the state together with that of the other party which forms the arbitration agreement as the basis of the jurisdiction of the arbitrator.<sup>186</sup> Therefore, in principle, considerations relevant to a state court such as equality of states and the foreign policy implications of taking jurisdiction over a foreign state should not be relevant to an arbitrator. A claim of immunity from the jurisdiction of an arbitral tribunal in a way would be the revocation of its consent to arbitrate. Whether or not such a revocation is permitted does not rest on the application and interpretation of the doctrine of sovereign immunity. What could affect the jurisdiction of an arbitral tribunal are defects of the state's consent to arbitration either due to a lack of capacity of the state or state party to conclude arbitration agreements (subjective arbitrability), non-arbitrability of the subject matter according to the relevant laws, or lack of authority of the party entering into the arbitration agreement on behalf of the state party.<sup>187</sup> Such defects can undermine the existence and validity of the arbitration agreement as the basis of the jurisdiction of the arbitral tribunal.

Moreover, the distinction between *acta jure imperii* and *acta jure gestionis* could not be relevant as a separate limiting ground from arbitrability. In other words, if, according to the relevant laws, the subject-matter is arbitrable, the arbitrator should not be concerned with the distinction of *imperii/gestionis* acts of state.<sup>188</sup> Whether the distinction would be relevant in determining the jurisdiction of courts in related proceedings is a separate question which would depend on the law applicable to the issue.<sup>189</sup>

A question may arise as to under which law the issue of immunity, including limits to the scope of the waiver, is decided. Is it entirely up to the arbitrator to decide whether or not a state is immune from the jurisdiction of an arbitral tribunal? A study

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<sup>186</sup> Wetter, *ibid.*

<sup>187</sup> Fox, H., Sovereign immunity and arbitration, *supra*, note 166 at 323.

<sup>188</sup> Wetter, *supra*, note 185 at 15.

<sup>189</sup> *Supra*, 5.4.

of the case law shows a degree of disagreement among arbitrators. In *Societe de Grands Travaux de Marseille v. East Pakistan Industrial Development Corporation* the arbitrator, sitting in Switzerland, decided the issue according to Swiss procedure and public international law.<sup>190</sup> In the *Westland Helicopters* case, however, the arbitrator, on the question of whether or not a state party may plead immunity from jurisdiction of an arbitral tribunal, reached a similar conclusion and decided the issue on the basis of the law of the place of arbitration.<sup>191</sup>

The issue has been treated differently by the proponents of a transnational model of arbitration. In the *ICC Case No.2321* concerning the question of which law had to apply to the issue of immunity, the defendant State contended that it had to be its law which was the applicable substantive law.<sup>192</sup> The claimant however argued for the application of the law of the place of arbitration: Sweden. The arbitrator's view was that the question had nothing to do with the proper law of contract.<sup>193</sup> He also did not rely on the Swedish law, as the law of the place of arbitration, to decide the question. He continued:

My authority as an arbitrator rests upon an agreement between the parties to the dispute and by my activities I do not, as State judges or state representatives do, engage the responsibility of the State of Sweden. Furthermore, the courts and other authorities of Sweden can in no way interfere with my activities as arbitrator, neither direct me to do anything I should not do nor to direct me to abstain from doing anything which I think I should do.<sup>194</sup>

Therefore, the arbitrator found himself independent from any system of law and decided the case accordingly. The arbitral tribunal in *ICC Case No.3493* reached a similar conclusion: "It would indeed be frustrating to recognise full force and effect of general principles of law aimed at protecting foreign investors and then admit that a state may, before an arbitral tribunal, rely upon domestic or international principles granting sovereign immunity as an excuse for acts amounting to contractual breaches."<sup>195</sup>

<sup>190</sup> (1980) 5 YBCA 179 at 185.

<sup>191</sup> *Westland Helicopters Limited v. Arab Organization for Industrialisation et al*, ICC case 3879 (1986) 11 YBCA 127.

<sup>192</sup> (1976) 1 YBCA 133.

<sup>193</sup> ICC case 2321 (1976) 1 YBCA 133.

<sup>194</sup> *Ibid.*

<sup>195</sup> *SPP v. Arab Republic of Egypt et al*, (1984) 22 ILM 752 at 771-774.

From the study of national laws, it would appear that the decision of an arbitrator on his jurisdiction is ultimately subject to the approval of the law of the place of arbitration. However, because there is a general recognition among national laws of the places normally chosen as seat of arbitration that a sovereign state, upon conclusion of a valid arbitration agreement, may not plead sovereign immunity, the role of those laws may not be so evident. The significance of applicable laws to immunity and their role is more evident in determining the scope of the waiver of immunity from the jurisdiction of courts in related proceedings rather than in deciding the jurisdiction of the arbitral tribunal.<sup>196</sup>

### 2.5.5 Act of State

The distinction between Act of State doctrine and sovereign immunity is clearly put in *I.A.M. v. OPEC*:<sup>197</sup>

The doctrine of sovereign immunity is similar to Act of State doctrine in that it also represents the need to respect the sovereignty of foreign States. The doctrines differ, however, in significant respects. The law of sovereign immunity goes to the jurisdiction of the court. The act of State doctrine is not jurisdictional. Rather, it is a prudential doctrine designed to avoid judicial action in sensitive areas. Sovereign immunity is a principle of international law recognised in the United States by statute. It is the States themselves as defendants who may claim sovereign immunity. The Act of state doctrine is a domestic legal principle, arising from the peculiar role of American courts. It recognises not only the sovereignty of foreign States, but the spheres of power of the co-equal branches of our government.<sup>198</sup>

This doctrine can be traced back to seventeenth century England which initially aimed to provide protection for individual government officials similar to that which the doctrine of sovereign immunity did for states.<sup>199</sup> However, further development of the doctrine occurred mainly in the United States where Chief Justice Fuller held:

"Every sovereign is bound to respect the independence of every other sovereign state, and the courts of one country will not sit in judgment on the acts of the government of another done within its own territory. Redress of grievances by reason of such acts must be obtained through the

<sup>196</sup> See chapter VI, *infra*, 6.2.3.

<sup>197</sup> *International Association of Machinists and Aerospace Workers v. OPEC*, 624 F.2d (9th Cir.1981) 1354 at 135; See also Shaw, *supra*, note 183, 128; Singer, M., *The Act of State Doctrine of the United Kingdom: An analysis with comparisons to United States practice*. (1981) 75 AJIL 283; Steiner and Vagts, *Transnational Legal Problems*, Mineola/New York: Foundation Press 1968. 584; Wetter, *Pleas of Sovereign Immunity and Act of Sovereignty before Interantional Arbitral Tribunals*. *supra*, note 182; Mann, F.A. *Foreign Act of State*, (1990) 106 L.Q.R. 352;

<sup>198</sup> *Ibid.* at 1359.

<sup>199</sup> *Blad v. Bamfield* [1674] 3 Swans, 604, cited in Singer, *supra*, note 197 at 322.

means available of by sovereign powers as between themselves<sup>200</sup>

It was stated in the frequently-cited case *Sabbatino* that " the judicial branch will not examine the validity of taking of property (by a foreign State) within its own territory.<sup>201</sup> The court also emphasised that the main rationale for the doctrine in US law is the 'separation of powers' and the fear of embarrassment to the executive from judicial interpretation of international law.<sup>202</sup> The *Sabbatino* pronouncement remains the main definition of the doctrine to which several limitations were made by the courts and legislature with the effect of narrowing the scope of its application.<sup>203</sup>

Following the enactment of the Foreign Sovereign Immunity Act,<sup>204</sup> which does not grant immunity to States in actions involving their participation in commercial activities, some courts examined the existence of a commercial activity exception to the act of state doctrine.<sup>205</sup> In one case, the court "declined to extend the act of state doctrine to situations where the sovereign descended to the level of an entrepreneur"<sup>206</sup> and in another recognised the 'price fixing' policy of OPEC as not being commercial and therefore applied the doctrine.<sup>207</sup> Also, when a court receives permission from the State department to adjudicate the case, the doctrine is not applicable.<sup>208</sup> Courts in the U.S. have also considered the existence of other exceptions to the application of the doctrine. One is the fraud exception in the cases of violation of U.S. anti-trust laws and international bribery. In *Clayco Petroleum V. Occidental Corp.* the United States Court of Appeals considered the possibility of a corruption exception to the Act of State doctrine.<sup>209</sup>

There could be a treaty exception when there are specific treaty provisions providing

<sup>200</sup> *Oetjen v. Central Leather*, [1918] 246 U.S. 297

<sup>201</sup> *Banco Nacional de Cuba v. Sabbatino* [1964] 376 U.S. 398 at 432.

<sup>202</sup> *Ibid.*

<sup>203</sup> An examination of the doctrine and its extent was conducted by the US Supreme Court in *Kirkpatrick v. Environmental Tectonics*, reproduced in (1990) 29 ILM 182.

<sup>204</sup> 1976, 28 U.S.C.A. ss 1330 and 1602-1611.

<sup>205</sup> *Alfred Dunhill of London v. Rep. of Cuba* [1976] 425 U.S. 482.

<sup>206</sup> *Ibid.*

<sup>207</sup> *I.A.M. v. OPEC*, 624 F.2d (9th Cir. 1981) 1354 at 1359.

<sup>208</sup> *Bernstein v. Van Heyghen Freres* 163 F.2d 246 (1947); *Bernstein v. Netherlandshe Amerikaansch Stoormvaart* 173 F.2d 71 (1947).

<sup>209</sup> 712 F.2d 404 (9th Cir. 1983).

the controlling legal principles. Therefore, in *American International Group v. Islamic Republic of Iran*, a case concerning the nationalisation of US insurance companies, the court relying on the existence of treaty provisions between Iran and the United States concerning the standard of compensation found that it was not precluded from reaching the merits by the Act of State doctrine.<sup>210</sup>

The Act of State doctrine in England is included in the doctrine of justiciability which has a wider scope.<sup>211</sup> Matters which fall within the competence of the executive branch of the government are not justiciable before the courts; it concerns both domestic and foreign executive acts.<sup>212</sup> The doctrine of non-justiciability of acts of foreign states is found in the speech delivered by Lord Wilberforce in *Buttes Gas and Oil Co. v. Hammer* :

"... there was a long-standing principle of English law, which was inherent in the very nature of the judicial process, that municipal courts would not adjudicate on the transactions of foreign states; that, accordingly, where such issues were raised in private litigation, the court would exercise judicial restraint and abstain from deciding the issues involving the court in reviewing transactions in which four sovereign States were concerned and being asked to find at least part of those transactions unlawful under international law, the issues raised were non-justiciable and incapable of being entertained by the court."<sup>213</sup>

Similar to the doctrine of Act of State in the US, the doctrine of justiciability may not apply to commercial acts done by a national on behalf of his respective state.<sup>214</sup>

#### 2.5.5.1 Act of State and Jurisdiction of Arbitrator

Lack of justiciability of disputes which involves a review of the validity of an act of a foreign state is a ground for courts not to take jurisdiction on such cases. As Lord Wilberforce puts it: "This principle is not one of discretion, but is inherent in the very nature of the judicial process."<sup>215</sup> Arbitral tribunals, however, are concerned with the

<sup>210</sup> 493 F.Supp.552 (D.D.C. 1980); Similarly see *Kalamazoo Spice Extraction Co. v. Provisional Military Government of Socialist Ethiopia*, 729 F.2d 422 (1984).

<sup>211</sup> Shaw, *International Law*, *supra*, note 183 at 131; also in *Buttes case* where the court considered the doctrine "not as a variety of "act of state" but one for judicial restraint or abstention. [1982] AC 888 at 931.

<sup>212</sup> Shaw, *ibid.* at 128.

<sup>213</sup> [1982] AC 888 at 890.

<sup>214</sup> Shaw, *supra*, note 183 at 131 (footnotes omitted).

<sup>215</sup> *Buttes case*, [1982] AC 888 at 932.

arbitrability of a claim as opposed to its justiciability.<sup>216</sup> In arbitration the special nature of the process would require the existence of an arbitration agreement between parties to the dispute which is usually in connection with a contractual relationship. The state itself, by concluding an arbitration agreement, consents to the process and also to the jurisdiction of the arbitral tribunal. Furthermore, the underlying policies for the application of the doctrine in national courts, including international comity, dignity of states in foreign jurisdictions, separation of powers and so on, do not exist in the case of an arbitration involving a foreign State. Therefore, in a case of "taking of property" by a foreign State, for example, an American court may not examine the validity of such an act; whereas the validity of the same act may be examined by an arbitrator pursuant to an arbitration agreement.

As mentioned, the jurisdiction of an arbitral tribunal is based on the agreement of the parties who agree to arbitration within the limits of arbitrability. Thus the question whether an act of state is arbitrable, or reviewable by an arbitral tribunal, should be answered by the relevant applicable laws.<sup>217</sup> Wetter maintains that "a most essential function of international arbitral tribunals is to adjudicate upon the transactions of sovereign states *within the jurisdictional bonds of valid arbitration agreements* (italics supplied).<sup>218</sup>

In the text of the Declaration of the Government of the Democratic and Popular Republic of Algeria, it seems that the two governments of Iran and the United States have intended to have their disputes resolved through arbitral adjudication of their cases regardless of the fact that the Act of State doctrine might otherwise be applicable.<sup>219</sup> However, in practice the Tribunal seems to have applied the doctrine in some cases. In *Iran v. United States, case B-1*, pursuant to contracts, which formed a part of the U.S. "Foreign Military Sales" programme, the U.S. was to deliver some

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<sup>216</sup> See in general Pavlis, P., *International Arbitration and Inapplicability of the Act of State Doctrine*, (1981) 14 *International Law and Politics* 65; also Wetter, J. G., *Pleas of Sovereign Immunity and Act of Sovereignty before Interantional Arbitral Tribunals*, *supra*, note 185.

<sup>217</sup> See *Arbitrability, supra*.

<sup>218</sup> Wetter, *supra*, note 185 at 18.

<sup>219</sup> Para.B of the General Principles of the Declaration reads: It is the purpose of both parties within the framework of the two declarations of the Government of the Democratic and Popular Republic of Algeria, to terminate all litigations as between the Government of each party and the national of the other, and to bring about the Settlement and termination of all such claims through binding arbitration."

military items already sold to Iran.<sup>220</sup> The United States stopped the delivery of the items by refusing to issue export licences because of the non-payment of the quarterly instalments by Iran and also on policy grounds. The United States' justification for non-delivery were the provisions of the Arms Export Control Act which empower the President to control the import and export of defence articles "[i]n furtherance of ...the security and foreign policy of the United States".<sup>221</sup> The Tribunal held that "... the President's exercise of the discretion conferred upon him by section 38 of the Act, to make a determination in highly sensitive political matters such as, as stated in that section, "world peace and the security and foreign policy of the United States", is the exercise of a sovereign right which is not subject to review by an international tribunal."<sup>222</sup> This, however, may be justified on the doctrine of political question which "operates to prevent the courts from considering issues of political delicacy in the field of foreign affairs."<sup>223</sup>

## 2.6 Conclusion

The study of the law and practice of arbitration on jurisdictional matters, in principle, points to a trend in favour of the expansion of jurisdiction of arbitral tribunals. The liberal approach taken by some national laws and by the rules of business arbitration institutions on the scope of the two doctrines of separability and competence/competence may lead to situations where, in determining the scope of its jurisdiction, the arbitrator may exercise almost uncontrolled powers. This could result in the assumption of jurisdiction by the arbitrator beyond the limits allowed by the relevant laws and also beyond the scope of arbitration agreement. Similarly, the concept of international public policy, as distinct from national public policy, has been introduced by some national laws to reduce the limiting effects of the relevant national public policies on the scope of arbitration. A number of arbitral awards and also national courts decisions, have taken an even more restrictive view of the public policy

<sup>220</sup> (1988) 19 Iran-U.S. C.T.R. 273.

<sup>221</sup> *Ibid* at 280.

<sup>222</sup> *Ibid* at 292.

<sup>223</sup> See Shaw, *supra*, note 183 at 131 (footnote omitted).

limitation of arbitration through the adoption of the notion of transnational public policy which is defined by arbitral tribunals and not national laws. This national laws and arbitral tribunals liberal approach is also reflected in relation to the question of the possible limiting effects of sovereign immunity and Act of State doctrines.

These developments may result in the exclusion of the possibility of imposition by the state party's law of public policy limitations on the capacity of the state to submit to arbitration as well as on the arbitrability of certain categories of disputes on the grounds of vital public interest. In other words, in principle, there could be situations in which an arbitrator may extend his jurisdiction beyond his mandate and the relevant public policy limits to cover matters relating to sovereign prerogatives of the state party. A situation of this kind is more likely to arise in arbitrations subject to national laws which have compromised more sovereignty in favour of arbitral autonomy in that the conduct of arbitration is free from judicial control. Given the restrictive position of the state party regarding the scope of arbitration, these arbitrations would appear to be incompatible with the state party's interests. As regards arbitrations whose jurisdictional determinations are subject to judicial control, arbitrations belonging to national laws which enforce foreign public policy limitations of subjective and objective arbitrability would appear to be more compatible with the public interest element of state contracts than those which do not recognise such limitations. The reason for this is that in the case of arbitrations which belong to the first category the applicability of the public policy limitations of the state party's law, including those relating to the contract, would not depend on the designation of that law as the governing law of the contract.

## Chapter III

### Control Function in Arbitration of State Contracts

#### 3.1 Introduction

The effectiveness of the decision of an arbitral tribunal depends largely on the degree of the conformity of the decision making process to the expectations of the parties. A number of values such as speed, fairness, correctness, finality and confidentiality may be relevant. Parties to an arbitration, according to their own underlying interests, may attach varying degrees of importance to a given value. In the arbitration of a business dispute between two private parties, in the light of the importance of promotion of contract stability and efficiency, values of speed and finality may be paramount.<sup>1</sup> It is largely for these reasons that the international business community is in favour of internationalisation of the regulation of international contracts and international commercial arbitration in that they favour a minimum level of control by the relevant national public policies on arbitration.<sup>2</sup> State parties to contract, however, favour a kind of procedure which would not infringe upon their sovereign prerogatives with regard to contract.<sup>3</sup> Such prerogatives may be relevant within the context of the arbitral tribunals's jurisdictional decisions, conduct of the proceedings, the determination of applicable substantive law and substantive remedies.

Whether the powers of the arbitrator comes from the parties' agreement or from a legal system, one thing is clear; such powers are limited to the extent agreed upon by those who delegated it.<sup>4</sup> Violations of such limits by the arbitrator would undermine the integrity of the process and the effectiveness of any decision emanating from it. Control mechanisms are there to ensure this integrity which in turn enhances the authority of the outcome of the process and its enforceability. In the words of Professor Reisman:

Controls are techniques or mechanisms in engineered artifacts, whether physical or social, whose function is to ensure that an artifact works the way it was designed to work. In social and legal arrangements in which limited power is delegated, control systems are essential: without them the

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<sup>1</sup> See Ch. I, *supra*, 1.3.3.

<sup>2</sup> *Ibid.*

<sup>3</sup> *Ibid.* at 1.3.4.

<sup>4</sup> Ch.II, *supra*, 2.2.

putative restrictions disappear and the limited power may become absolute.<sup>5</sup>

In the context of arbitration, the rationale of judicial control and its necessity was emphasised by Kerr L.J.:

No one having the power to make legally binding decisions ... should be altogether outside and immune from this system. This system is our bulwark against corruption, arbitrariness, bias, improper conduct and -where necessary- sheer incompetence in relation to acts and decisions with binding legal effect for others. No one below the highest tribunals should have unreviewable legal powers over others. Speaking from experience, I believe this to be as necessary in relation to arbitrations in England and abroad as in all other contexts.<sup>6</sup>

The imposition of any kind of control over the procedure of arbitration would involve to a degree the reviewability of the conduct of arbitration. There are basically two different approaches to the question of the reviewability of the arbitral process and awards.<sup>7</sup>

One school of thought regards any form of review as undermining the finality of the award which is considered as the fundamental purpose of the arbitral process. Awards must be accepted even if they are unjust.<sup>8</sup> At the international level, in the absence of a controlling body, the recognition of the possibility of the nullification of an award "would create an uncontrollable means for repudiating decisions, which could devastate the foundation of international arbitration."<sup>9</sup> At a national level, it is argued, a control function entrusted to the courts would allow them to subject arbitration to the peculiarities of the national law in many cases unintended by the parties.<sup>10</sup> Furthermore, potential remedies provided by national laws as means of control may be abused by a dissatisfied party to delay compliance with the decision of the arbitral tribunal.<sup>11</sup>

There is a second school of thought which considers the control of the arbitral process a necessary element in enhancing the authority and enforceability of the

<sup>5</sup>Reisman, M., *Systems of Control in International Adjudication and Arbitration*, 1992, cited from Reisman, M., *Repairing ICSID's Control System: Some Comments on Aron Broches "Observations on the Finality of ICSID Awards"*, (1992) 7 ICSID Rev.-FILJ 196, at 198.

<sup>6</sup> Kerr, L. J., *Arbitration and the Courts, the UNCITRAL Model Law*, (1985) 34 ICLQ 1.

<sup>7</sup>See, in the context of international law, Lauterpacht, *Aspects of Administration of International Justice*, Cambridge:Grotius 1991, Ch. VI.

<sup>8</sup> See in general Reisman, *Nullity and Revision: The Review and Enforcement of International Judgments and Awards*, New Haven and London:Yale University Press 1971 at 21.

<sup>9</sup> *Ibid.* at 22.

<sup>10</sup> Craig, *Uses and Abuses of Appeal*, (1988) 4 Journal of International Arbitration, 185.

<sup>11</sup> *Ibid.* at 218-224.

resulting decision. Proponents of this view do not see the possibility of control as a threat to the authority of the decision which could be under a more serious threat when being defective. The mere possibility of a review process could act as an inducement for arbitral tribunals to conduct the proceedings and to formulate their awards in a way which would avoid the occurrence of grounds of review.<sup>12</sup>

Apart from the parties to arbitration, there may be others with an interest in the way arbitral proceeding is conducted such third parties, the state where the arbitration takes place and the state where the enforcement of the award is sought. As will be seen below, these states consider themselves entitled to impose some level of supervision over arbitration.<sup>13</sup> Therefore, when considering the question of judicial control of the arbitral process one has to bear in mind an interaction between various interests.

Control function in arbitration is relevant with regard to matters of jurisdictional determinations, conduct of the proceedings, the determination of the applicable substantive law, substantive remedies and the award.

### 3.2 Procedural Remedies

Control over arbitration is usually achieved through procedural remedies provided for by the agreement of the parties and by the relevant applicable laws. In principle, in international arbitral process three forms of remedies may be distinguished: revision, appeal and annulment.<sup>14</sup> Revision is a remedy whereby an award is remitted for amendment to the arbitral tribunal which originally rendered it. An award may be remitted to the tribunal to give it a chance to correct it so that the grounds for setting it aside are eliminated<sup>15</sup>, or to consider newly discovered facts which were unknown

<sup>12</sup>One of the main reasons for the SPP to settle for an amount considerably lower than the amount awarded by the ICSID tribunal was the risk involved in any likely annulment proceeding. See Craig, *The Final Chapter in the Pyramids Case: Discounting an ICSID Award for Annulment Risk*, (1993) 8 ICSID Rev.-FILJ 264 at 290.

<sup>13</sup>See *infra*, 3.3.1.

<sup>14</sup>Redfern and Hunter, *Law and Practice of International Commercial Arbitration*, 2nd edition. London: Sweet and Maxwell 1991, 432; also see Wetter, J. G., *International Arbitral Process: Public and Private*, New York: Dobbs Ferry 1979, Vol. II at 539.

<sup>15</sup>E.g. Art.34(4) of the Model Law:

"The court, when asked to set aside an award, may, where appropriate and so requested by a party, suspend the setting aside proceedings for a period of time determined by it in order to give the arbitral tribunal an opportunity to resume the arbitral proceedings or to take such other action as in the arbitral tribunal's opinion will eliminate the grounds for setting aside."

when the award was rendered and could be of relevance to the outcome of the arbitration.<sup>16</sup> An appeal takes the award to a body different from the tribunal which rendered it. The appellate body may be a court of law or another arbitral tribunal.<sup>17</sup> An appellate body may review the award on its merits and examine the correctness of its substance as well as the legitimacy of the procedure used.<sup>18</sup> It is argued that there ought to be only a limited right of appeal in arbitration since "limited rights to judicial review are one aspect of the doctrine that parties who choose arbitration are intentionally choosing not to have the advantages and disadvantages of the courts."<sup>19</sup> Annulment is a remedy sought before an authority to set aside the award and to declare it null on grounds such as serious violation of fundamental principles of procedure, corruption, excess of power and the like. The annulment of an award may not normally be sought on the ground that the tribunal has erred on some points of law or fact.<sup>20</sup>

Whether or not an arbitration is subject to control with regard to the conduct of the proceeding and validity of the award depends on the agreement of the parties and the relevant applicable laws to arbitration. It is a well known fact that many disputes are settled by arbitral tribunals without any particular law being expressly referred to. The reason may be that the issue is entirely factual or the application of various laws to the substance of the dispute would lead to the same conclusions. This, however, does not mean that such arbitrations are conducted and disputes decided outside the boundaries of law.<sup>21</sup>

In the context of international commercial arbitration, a number of national laws may be relevant including laws governing the parties' capacity to enter into the arbitration

<sup>16</sup> E.g. Art.51(1) of the Washington Convention.

<sup>17</sup> This is usually the case in arbitration of commodity agreements and other arbitrations established by trade associations. Redfern & Hunter, *supra*, note 14 at 419 (footnotes omitted).

<sup>18</sup> Caron, D., Reputation and Reality in the ICSID Annulment Process: Understanding the Distinction between Annulment and Appeal, (1992) 7 ICSID Rev.-FILJ 21 at 23-25.

<sup>19</sup> Craig, Uses and Abuses of Appeal, *supra*, note 10 at 183.

<sup>20</sup> E.g. Art.34 the UNCITRAL Model Law which contains an exhaustive list of grounds according to which an award may be challenged in the place of arbitration. This list does not include any ground for challenge of an arbitral award on the ground of arbitral tribunal's error in law or facts.

<sup>21</sup> It could be that the circumstances of the case, the factual nature of the matter in dispute or the absence of any disagreement on the question of the applicable law render any express reference to the question superfluous. See also Wetter, J. G., *International Arbitral Process*, *supra*, note 14, Vol.IV at 285.

agreement, the validity of the arbitration agreement, the establishment and the proceedings of the arbitration, substantive issues and those laws relevant at the stage of recognition and enforcement of the arbitral award.<sup>22</sup> In such arbitrations, the control function with respect to the legitimacy of the arbitral process and the substantive correctness of its outcome may operate in place of arbitration or where the award is sought to be enforced. It is the law governing the procedure, normally that of the place of arbitration, which offers remedies whereby the validity of an award may be challenged. Almost all developed national systems of law provide for some kind of control over arbitrations taking place in their territory.<sup>23</sup> They may however differ in the degree of control exercised and the kinds of procedural remedies they provide.

In arbitrations subject to public international law, usually interstate arbitration and other non-national arbitrations, national courts normally have no control over the procedure. In such arbitrations, control remedies are to be searched for in international law and in the rules of procedure of those arbitrations as agreed by the parties. For example, Art. 30 of the International Law Commission Draft Convention on Arbitral Procedure of 1953 provides for a challenge procedure against the validity of an award on the ground "(a) that the tribunal exceeded its powers; (b) that there was corruption on the part of a member of the tribunal; (c) that there was a serious departure from the fundamental rule of procedure, including failure to state reasons for the award."<sup>24</sup> The Statute of the International Court of Justice<sup>25</sup> and the case law<sup>26</sup> point to the availability of procedural remedies. In the context of state contracts, mention should be made of Art. 52 of the ICSID Convention which provides for grounds for challenge and remedies against awards which will be discussed in the second part of this chapter.<sup>27</sup>

<sup>22</sup> Redfern and Hunter, *supra*, note 14 at 72.

<sup>23</sup> *Ibid.* at 429.

<sup>24</sup> Reproduced in Wetter, *International Arbitral Process*, *supra*, note 14, Vol.V at 228.

<sup>25</sup> Art.61(1) of the Statute of the ICJ:

An application for revision of a judgment may be made only when it is based upon the discovery of some fact of such a nature as to be a decisive factor, when the judgment was given, unknown to the Court and also to the party claiming revision, always provided that such ignorance was not due to negligence.

<sup>26</sup> See *The Orinoco Steamship Co. Case* before the Permanent Court of Arbitration, 11 R.I.A.A. 233 summary produced in Schwarzenberger, G., *International Law as Applied by International Courts and Tribunals*, London:Stevens & Sons 1986, 706; *Arbitral Award Rendered by the King of Spain Case*, ICJ Reports, 1960, 192.

<sup>27</sup> See below, 3.4.21.

### 3.2.1 Applicable procedural Law of International Commercial Arbitration

How an arbitral tribunal is set up and the way it conducts the proceedings are regulated by the rules applicable to the procedure of arbitration. Such rules may be agreed upon by the parties or they may be left to the arbitrator to decide. Alternatively, the parties may choose to subject the arbitration to the rules of their chosen arbitration institution. The parties' right to decide on the procedure of arbitration is recognised by many national laws, and by various conventions in the field and arbitration practice.<sup>28</sup> There are however some matters which may not be decided by the parties. With regard to these matters rules of the applicable law of arbitration come into play. Matters such as objections to jurisdictional decisions of the arbitral tribunal, or removal of the arbitrator on the ground of misconduct, partiality or matters relating to serious irregularities in arbitral proceedings should be dealt with by a competent court. It is the law governing the arbitration which would point to such a competent court and the procedural remedies available.<sup>29</sup>

On the question of the governing law of arbitration, depending on the view taken on the legal nature of arbitration, different schools of thought are distinguishable.<sup>30</sup> Those following the jurisdictional and mixed theories of arbitration consider the procedure a matter for the law of the place of arbitration.<sup>31</sup> According to this view, the parties' freedom to choose, replace or modify the rules applicable to the procedure of

<sup>28</sup> See in general Sanders, P., Trends in the field of international commercial arbitration . (1975) 145 RCADI 205 at 271-2. The freedom of parties to decide on the rules of procedure has been recognised by national laws and rules of arbitration.

<sup>29</sup> Redfern and Hunter, *supra*, note 14 at 83. Furthermore, there are occasions when an arbitral tribunal may need the assistance of a court to proceed with the proper conduct of arbitration. For example, an arbitral tribunal does not have any power with regard to third parties. Therefore, in such situations, an arbitral tribunal may need the intervention of a court to assist it with matters such as calling witnesses or freezing bank accounts, etc. The law governing the arbitration would guide the arbitral tribunal in finding the competent court. It is the procedural law of arbitration which determines where the award is made and hence the nationality of the award which according to the relevant conventions could be of great importance in the enforcement of the arbitral award. Conflict-of-laws rules are very often part of the procedural laws of a legal system. These rules may play an essential role in identifying the applicable legal standards to the substance of the controversy. In an arbitration, therefore, the law governing the arbitration could assist the tribunal in its determination of the law applicable to the substance of the dispute as well as in matters of procedure. On the role of the conflict-of-laws rules of the place of arbitration in determination of the applicable substantive law see Ch. IV, *infra*, 4.2.

<sup>30</sup> On the legal nature of arbitration see Ch. I, *supra*, 1.3.1.

<sup>31</sup> Lew, J., *Applicable Law in International Commercial Arbitration*. Dobbs Ferry, New York: Oceana Publication 1978, at 52-4 & 57-59; Luzzatto, R., *International Arbitration and the Municipal Law of States*, (1977) 157 RCADI 9 at 51.

arbitration is rooted in the law of the place of arbitration. It is that law which sets the limits to the parties' choice. The arbitration and the resulting award will have the nationality of the country where the arbitration takes place.<sup>32</sup>

Proponents of the contractualist theory of arbitration, seeking a transnational independent model of arbitration, argue that, being the creation of the parties' will, arbitration is free from its seat. Parties may choose any law or set of rules to govern the arbitration, and their choice is not limited to the law of the place of arbitration.<sup>33</sup> They may, indeed, delocalise the whole procedure of arbitration. As a result, both the arbitration proceedings and the award would be free from the supervision and control of courts of the seat of arbitration.<sup>34</sup>

### 3.3 Control of Arbitration in National Laws

National laws take different views on the level of control of the conduct of arbitration. Various factors may be relevant such as the rivalry between state courts and arbitral tribunals, the cause of promotion of the place as a situs for international commercial arbitration, and considerations of development of national law.

#### 3.3.1 *Lex loci arbitri*

Traditionally, the law of the place where the arbitration takes place, '*lex loci arbitri*' or law of the 'seat', governs the procedure of arbitration including judicial control of the proceedings.<sup>35</sup>

"The country where the award is rendered traditionally has legitimised arbitral authority subject to conditions, in the form of mandatory procedural rules imposed on the arbitral proceedings."<sup>36</sup>

According to this doctrine there is a territorial link between the 'seat' of the

<sup>32</sup> *Ibid.*

<sup>33</sup> Lew, *Applicable Law*, *supra*, note 31 at 54-57.

<sup>34</sup> It should be born in mind that despite the strong desire for the procedurally delocalised arbitration expressed by international business and some arbitral tribunals, the complete delocalisation of procedure without the permission of the national laws is not possible. Sanders, P., *supra*, note 24 at 272; Mann, F. A., *Lex facit arbitrum*, In *International Arbitration: Liber amicorum for Martin Domke*, Edited by P. Sanders, The Hague: 1967, 157; Craig, W. L., W. W. Park and J. Paulsson, *International Chamber of Commerce Arbitration*, New York: Oceana Publications, Inc.: ICC Publishing S.A. 1990, 439.

<sup>35</sup> Park, W., *Judicial Controls in the Arbitral Process*, (1989) 5 *Arbitration International* 230; Park, W., *The lex loci arbitri and international commercial arbitration*, (1983) 32 *ICLQ* 21; Mann, F. A., *ibid.*

<sup>36</sup> Park, in "The *lex loci arbitri* and international commercial arbitration", *ibid.* at 21.

arbitration and the law applied to the procedure. The theoretical basis of the doctrine lies in the exclusive right of states to administer justice in their territory. Private justice administration is the exception, the scope of which should be determined by the state law and that, in order to uphold the 'integrity of the arbitral process', a level of supervision over the conduct of arbitration should be maintained.<sup>37</sup> It is for the state to decide, according to its national jurisdictional and public policies, which category of claims can be submitted to arbitration in its territory. It is also argued that due to the support that is given by national laws to arbitral tribunals, they owe a duty to the losing party to provide him with safeguards against misconduct by such tribunal.<sup>38</sup> The major underlying reasons for the 'seat' theory may be summed up as state territorial jurisdiction, integrity of arbitral process, the right of the losing party and the third parties in arbitration, and promotion of the values of certainty and predictability.

On the impact of the doctrine, as already noted, arbitration will be subject to the judicial control by national courts. This control may include review of the substance of the decisions of the arbitral tribunal as well as the conduct of the proceedings.<sup>39</sup> Furthermore, by being rendered in the territory of a given state, an award may acquire the nationality of that place and thus, in respect of recognition and enforcement may enjoy the treatment provided by the international treaties and conventions to which the state of the seat is a party.<sup>40</sup> Moreover, one of the greatest impacts of the doctrine would be on the determination of the law applicable to the substance of the dispute.<sup>41</sup> Thus, the rules of choice of law in force in the State of the seat of the arbitral tribunal must be followed to settle the law applicable to the substance of the difference.<sup>42</sup>

<sup>37</sup> Park, *Judicial Control in the Arbitral Process*, *supra*, note 35.

<sup>38</sup> *Ibid.* at 231.

<sup>39</sup> E.g. judicial control under the 1955 and 1975 UK Arbitration Acts; Commentary see, Mustil, R. , and Boyd, *The law and practice of commercial arbitration in England*, 2nd ed., London:Butterworths 1989, Chs.33 and 36.

<sup>40</sup> The New York Convention provides for a regime of recognition and enforcement of foreign awards i.e. awards bearing a nationality other than that of the country where the recognition and enforcement is sought. See Redfern and Hunter, *supra*, note 14 at 84; Also the discussion of the Convention regime in Ch.VI . *infra*. 6.1.1.

<sup>41</sup> See, for instance, the *ICC Case No. 5460*: "The place of this arbitration is London, and on any question of choice of law I must therefore apply the relevant rules of the private international law of England." in (1988) XIII YBCA 104 at 106; See the discussion of the applicable substantive law and conflict of laws in Chapter IV, *infra*.

<sup>42</sup> Mann, *Lex facit arbitrum*, *supra*, note 34 at 157.

Autonomy of the parties is limited to the extent allowed by the law of the seat.<sup>43</sup>

The doctrine has influenced many national laws. For example, the application of Swiss law to arbitrations which have their seat in Switzerland, provided that one of the parties has neither its domicile nor its habitual residence in Switzerland, is mandatory.<sup>44</sup>

In the United Kingdom, courts have a wide range of powers with respect to arbitrations held within their jurisdiction.<sup>45</sup> In the absence of an exclusion agreement, which could eliminate to a great extent the courts' power to review the award, there will be a right of appeal against the award on points of law.<sup>46</sup> Furthermore, an award may be set aside on the ground of arbitrator's misconduct whether or not there has been an exclusion agreement.<sup>47</sup>

The French law, being known for its liberal approach toward international commercial arbitration, still retains a certain degree of attachment between the seat and proceedings of arbitration.<sup>48</sup> Title V of Book IV of The Code of Civil Procedure deals with international arbitration covering any arbitration which involves 'international commercial interests'<sup>49</sup> According to Art.1494 there is no *ipso jure* application of the French procedural law to international arbitrations. The Code, however, provides for a setting aside procedure against awards rendered in France in international arbitral proceedings grounds of which are set out in Art. 1502.<sup>50</sup> These are the same as grounds for appeal against a decision granting recognition and enforcement of awards rendered abroad or international awards.

<sup>43</sup> *Ibid.*; For a recent endorsement of the seat theory see *Union of India v. McDonnell Douglas Corporation*, High Court Queen's Bench Division, [1993] 3 Lloyd's Reports 48.

<sup>44</sup> Art.176(1) of the Swiss Private International law, Act of 1987; for a general study of Swiss law on arbitration see Bucher, A. and P. Tschanz, *International Arbitration in Switzerland*, Basle:Helbing and Lichtenhahn 1989.

<sup>45</sup> Mustil, R. and Boyd, *The law and practice of commercial arbitration in England*, 1982 Boyd, S., *supra*, note 39. The role of national law and the national courts in England, In *Contemporary Problems in International Arbitration*, edited by Lew, London: Kluwer, 1986, 149.

<sup>46</sup> Arbitration Act 1979 § 1.

<sup>47</sup> Arbitration Act 1950 § 23; See also Arts. 28(1) and 32 of 1994 English Draft Arbitration Bill on matters of appeal and exclusion agreements.

<sup>48</sup> For a general study of the French legislation see Audit, B., A National Codification of International Commercial Arbitration: The French Decree of May 12, 1981., In *Resolving Transnational Disputes Through International Arbitration*, Edited by T. Carbonneau, Charlottesville: University Press of Virginia 1984, 117-145.

<sup>49</sup> Art.1492 of the French Code of Civil Procedure.

<sup>50</sup> Art.1504.

The German law gives the parties and the arbitrators the freedom to design the rules of procedure<sup>51</sup> subject to a degree of court supervision.<sup>52</sup>

The UNCITRAL Model Law also adopts the seat theory.<sup>53</sup> An action for setting aside an award should be brought before courts of the state where the arbitration is held.<sup>54</sup> Under the regime of the New York Convention laws of "the country where the arbitration took place"<sup>55</sup> and "of the country where the award is made"<sup>56</sup> are relevant with regard to recognition and enforcement of the award. Those laws have a control role to play; an award may be refused recognition and enforcement if it has been "set aside or suspended in the country in which, or under the law of which, that award was made."<sup>57</sup>

Apart from those established under the terms of a treaty or an international convention, institutional arbitrations are to a varying degree subject to the control of their seat.<sup>58</sup> Art.13(2) of the Arbitration Rules of the USSR Chamber of Commerce and Industry provided that "the Arbitration Court shall apply to the proceedings the present rules and legislative norms of Soviet law related to international commercial arbitration."<sup>59</sup> ICC arbitration, international in aspiration and in the nature of its claims, is linked to the law of its situs since Art. 24(1) of the ICC Rules acknowledges the possibility of control of arbitration by local courts.<sup>60</sup>

The 'seat' theory has also been acknowledged by a great number of arbitral awards. In the *ICC Case No. 5029*<sup>61</sup>, an arbitration held in the Netherlands, the defendant argued that the clause that "The contract shall be deemed to be an Egyptian contract and

<sup>51</sup>Art.1034 of the German code of civil procedure (ZPO) translation and commentary provided by Glossner, O., National Report on Arbitration, F.R.Germany, In *Handbook Commercial arbitration*, Edited by P. Sanders. Deventer: Kluwer 1987.

<sup>52</sup> Art.1041 of the ZPO.

<sup>53</sup> See Art.1(2) of the Model Law.

<sup>54</sup> See Arts. 34 and 6 of the Model Law.

<sup>55</sup>Art.V (1)(d) of the New York Convention.

<sup>56</sup>Art. V. (1)(a) and (e) of the New York Convention.

<sup>57</sup>Art.V.(1)(e) of the New York Convention.

<sup>58</sup>For a detailed account of different types of arbitral institutions and their legal status see David, R., *Arbitration in international trade*, Deventer/London: Kluwer 1985, 40.

<sup>59</sup> Strohbach, H., National Report on CMEA Countries, in *Handbook Commercial Arbitration*, *supra*, note 47

<sup>60</sup> Questions of control and procedural remedies provided by the ICC system is studied further in this chapter.

<sup>61</sup> Interim Award of 16 July 1986, reprinted in (1987) XII YBCA 113.

shall be governed by and construed according to the laws in force in Egypt” required the application of the Egyptian law to the procedure of arbitration. The Tribunal did not agree with this view and held that the law of the place of arbitration, the Netherlands, applied.<sup>62</sup> Tribunals have respected parties’ choices of rules of arbitral institutions within the limits of mandatory rules of the procedural law of the place of arbitration. Therefore, in the *ICC Case No. 5485*, an arbitration held in Zurich, the tribunal was of the view that since Zurich was the place of arbitration the procedure had to be governed by the ICC Rules and the Zurich Rules of Civil Procedure.<sup>63</sup>

*Ad hoc* tribunals dealing with state contracts have also often applied the law of their seat to the procedure of arbitration.<sup>64</sup> In the *Alsing case*, an arbitration held in Lausanne, the umpire pursuant to rules of procedure agreed by the parties subject to his power of amendment, decided to apply the Swiss federal law of civil procedure to all questions not covered by the rules agreed by the parties.<sup>65</sup> The arbitrators in the *Sapphire* and *BP* arbitrations also chose to apply the procedural laws of the place of arbitration.<sup>66</sup> The basis of their approach to the question was the need for state supervision of the procedure<sup>67</sup> and considerations relating to the enforceability of the award.<sup>68</sup> In a more recent case, *Wintershall AG et al v. The Government of Qatar*, an arbitration held in The Hague, The tribunal upheld the parties choice of the UNCITRAL Arbitration rules “subject to any mandatory provisions of the Netherlands Arbitration law, which in the event of conflict with any of the UNCITRAL Rules, shall prevail.”<sup>69</sup>

The application of the procedural law of the place of arbitration is favoured by those

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<sup>62</sup> *Ibid.* at 114.

<sup>63</sup> *ICC Case No. 5485* (1987) XIV YBCA 156.

<sup>64</sup> Mann contends that the application of other laws by *ad hoc* tribunals is an exception to the rule. See, in detail, Mann, F. A., *State Contracts and International Arbitration*, In *Studies in International Law*, Oxford: Clarendon Press 1973, 256.

<sup>65</sup> *Alsing Trading Company, Ltd., and the Swedish match Company v. The Greek State*, Award of 22 December, 1954, Schwebel, *The Alsing Case*, (1959) 8 ICLQ, 320 at 327-29.

<sup>66</sup> *Sapphire International Petroleum Ltd. v. National Iranian Oil Company (NIOC)*, Award of 15 March 1963, 35 ILR 137; *BP Exploration Company (Libya) Ltd. v. The Government of the Libyan Arab Republic*, 53 ILR 297.

<sup>67</sup> 35 ILR 137 at 169.

<sup>68</sup> 53 ILR 297 at 309.

<sup>69</sup> Final Award of 31 May 1988, reprinted in (1990) XV YBCA 34

who consider a level of supervision over the process of arbitration necessary. It is also compatible with the external needs of arbitration wherever the assistance of courts is required. Parties to an arbitration would be able to know, in advance, the rules governing the proceedings. In this sense the 'certainty' and 'predictability' of the process are enhanced. However, there could be some reasons for the parties' reluctance to have their arbitration governed by *lex loci arbitri*. A major criticism to the application of *lex loci arbitri* is that national laws, as noted, in return for making arbitration agreements and awards enforceable, tend to exercise some judicial control over the arbitral process and the resulting award. Such control may extend to the merits of the arbitrator's decision on points of fact or law which may not be compatible with the expectation of parties to an international commercial arbitration i.e. the final resolution of their dispute by the judge of their own choice.<sup>70</sup> Moreover, the unnecessary introduction of the peculiarities of the national law into the procedure of a totally unconnected arbitration would lead to a rigidity of the procedure not compatible with the 'flexibility' required in arbitration of international commercial disputes.<sup>71</sup> Furthermore, the dispute concerned, may involve elements which it is in the parties' interest to ensure non-disclosure to their rivals or to the public at large. As for the state parties, internal and external political considerations may exist which make them prefer an entirely confidential procedure. Any court interference with the arbitration would be bound to bring some of or the entire record of the arbitration into the public domain. A further major criticism of the application of the rules of the *lex loci arbitri* to arbitration lies in the fact that recourse to the courts of the place of arbitration by a dissatisfied party, through invoking some grounds of *lex loci arbitri*, is very often a guise for causing delay either in the proceedings or against the award becoming 'final'.<sup>72</sup>

It was noted above that states may be less reluctant to agree to arbitration than to

<sup>70</sup>Craig *et al.*, *International Chamber of Commerce Arbitration*, *supra*, note 34 at 440.

<sup>71</sup>Toope, *Mixed International Arbitration*, Cambridge: Grotius 1990, 32.

<sup>72</sup> There may be many reasons for a losing party, such as holding on to the money that he should pay the other party, to try to delay the outcome of the proceedings. This may especially happen when the market interest rate is higher than the interest ordered by the tribunal. The problem of delay in general is considered in detail in Van den Berg, A. J. I. *Preventing delay and disruption of arbitration, II. Effective proceedings in construction cases*. Congress Series 5. Edited by v. d. Berg. 614, Deventer & Boston: Kluwer 1991.

appear before a foreign court.<sup>73</sup> The reason for this is that it would be incompatible with the “dignity of state” to appear before a foreign court; the same rationale as that underlying the doctrine of sovereign immunity.<sup>74</sup> An agreement by a state to arbitration is seen as a waiver of immunity with regard to the related courts proceedings. States are not usually willing to submit to arbitration to be held in a place whose laws follow a too interventionist approach.<sup>75</sup> As will be seen later, there may be, however, other reasons for states to prefer a level of judicial control over arbitration.

### 3.3.2 The Movement away from *lex loci arbitri*

For the above reasons, many argue for a shift from the automatic application of the law of the place of arbitration which is very often chosen for reasons other than submitting to the procedural laws of that place.<sup>76</sup> They support wider autonomy for arbitral tribunals to devise rules of procedure and less or non-intervention by the courts of the place of arbitration.<sup>77</sup> In the extreme, the argument goes as far as totally detaching international commercial arbitration from its seat.<sup>78</sup>

#### 3.3.2.1 Distinction between Domestic and International Arbitration

As noted earlier, the control and supervision normally exercised by courts of the place of arbitration can reduce the level of ‘confidentiality’, ‘speed’, ‘finality’ and ‘informality’ of the process favoured by the international business community. Indeed, there are cases where steps to set aside an arbitral award are taken just to delay recognition and enforcement of the award. Therefore, a case is made for a kind of arbitration free from the excessive intervention of the law and courts of its seat. To meet

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<sup>73</sup>Ch. I *supra*, 1.3.4.

<sup>74</sup>*Ibid.*

<sup>75</sup>One major reason for the introduction of the 1979 Arbitration Act was the concern expressed by the experts that the interventionist approach of the English courts towards international arbitration was largely contributing to states not agreeing to arbitration in England based on their fear of being subjected to unwanted court proceedings. See Diplock, L., *The Conflict Between Invisible Earnings and the Courts' Prerogatives: The Debate in the House of Lords on 15 May 1978 on Reform of English Arbitration Law*, (1978) House of Lords Official Reports, Columns 103; also Delaume, G., *State Contracts and Transnational Arbitration*, (1981) 75 AJIL 784 at 793.

<sup>76</sup>Smit, H., *Substance and Procedure in International Arbitration: The Development of a New Legal Order*, (1991) 65 Tulane Law Review, 1309 at 1313.

<sup>77</sup>*Ibid.*

<sup>78</sup>E.g. Swiss and Belgian legislations discussed below.

the needs of the business community, and in line with the policy of reducing courts caseloads and also in order to secure their share of the lucrative market of arbitration, legislatures in a number of countries have introduced more liberal arbitration laws narrowing the scope for the intervention of their courts in the procedure of international commercial arbitration taking place in their territory.<sup>79</sup> The result of this policy has been the introduction of legislation which reduces the level of control on arbitration exercised by national law in that there will be more autonomy for the parties and arbitral tribunals dealing with international cases. Therefore, a distinction is made between domestic and international arbitration.

The U.K. 1979 Arbitration Act allows the parties to exclude judicial review of the award on a point of law in international disputes<sup>80</sup> with the exception of disputes relating to insurance, commodities, or shipping.<sup>81</sup> Preeminence of English law in the latter areas and that "judicial review of such cases would be fruitful to the continued development of English law" were argued as grounds for their exclusion.<sup>82</sup> Before the introduction of this Act, courts in the United Kingdom had broad powers with respect to appeals against awards on questions of law.<sup>83</sup> The setting aside procedure of the earlier Act for cases when an arbitrator misconducts himself or the proceedings remains in force.<sup>84</sup> Courts in England appear to have followed the approach taken by the new legislation. The decision of House of Lords in the recent case, *Channel Tunnel Group v. Balfour Beatty Ltd.* is a clear demonstration of the acceptance by English courts of the distinction between domestic and international arbitrations, and of the adoption of a less-interventionist but supportive approach with regard to international arbitrations.<sup>85</sup> The case concerned a dispute relating to a contract according to which Balfour were to build a tunnel between England and France, and by a letter of variation to construct a cooling system. Clause 67 of the contract

<sup>79</sup> See, for example, Lord Diplock, *supra*, note 75.

<sup>80</sup> 1979 Arbitration Act, Section 3.

<sup>81</sup> *Ibid.*, Section 4.

<sup>82</sup> Park, The Influence of National Legal Systems on International Commercial Arbitration: Recent Development in English Arbitration, In *Resolving Transnational Disputes Through International Arbitration*. Edited by T. Carbonneau, Charlottesville: University Press of Virginia 1984, 80 at 96.

<sup>83</sup> 1950 Arbitration Act, Art.

<sup>84</sup> Section 23, 1950 Arbitration Act.

<sup>85</sup> [1993] 2 WLR 262 (H.L.)

provided for the initial reference of disputes or differences, including disputes as to the valuation of variations, to a panel of experts and provided for the final settlement by arbitration in Brussels. A dispute arose as to the amounts payable in respect of the work on the cooling system. Alleging that the Channel Group were in breach of contract, Balfour threatened to suspend that work. The Channel Group issued a writ seeking an injunction to restrain Balfour from suspending the work. Balfour invoking the arbitration agreement sought to stay the Channel Group's action in favour of arbitration. One of the questions raised in the case was whether the English courts possessed the power to stay proceedings in relation to an arbitration agreement such as the one in the case which could not immediately and effectively be applied. The House of Lords in confirming the judgment of the Appeal Court held that under the 1975 Arbitration Act there was an inherent power to order a stay of court proceedings in relation to an arbitration agreement such as the one in question.<sup>86</sup> This power could also be exercised under section 1 of the 1975 Act since it is possible to stay the action without referring the matter to arbitration.<sup>87</sup> Furthermore, the House took the view that English courts should exercise their power to order interim relief to reinforce international arbitration.<sup>88</sup> However, later a more interventionist approach was adopted by House of Lords in *S.A. Coppee Lavalin v. Ken-Ren Chemicals and Fertilizers Ltd.* where the role of courts to order security for cost of arbitration was reaffirmed.<sup>89</sup>

In France before the introduction of the Decree of May 12, 1981, there was no distinction in the law between domestic and international arbitration. However, there was confusion among courts as to how to treat international arbitration. Some courts, in line with a *laissez faire* attitude towards international arbitration, tried to fashion a

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<sup>86</sup> *Ibid.* at 275-277.

<sup>87</sup> In this case, the difference between Section 1(1) of the 1975 Act which requires courts to order stay of proceedings when an action is brought in breach of an arbitration agreement on the one hand and Art. II (3) of the New York Convention which requires the court seized of the matter to, at the request of one of the parties, refer the parties to arbitration, justified the order to stay proceedings as under the UK Act there was no obligation for the court to, upon an order to stay proceedings, refer the case to arbitration which would have been in contradiction with the clause 67 of the contract providing for disputes to be initially referred to a panel of experts. *Ibid.* at 277-278.

<sup>88</sup> *Ibid.* at 291.

<sup>89</sup> [1995] 1 AC 38. Commentaries see Davenport, B., *The Ken Ren Case: Much Ado About Nothing Very Much*, (1994) 10 *Arb.Int.* 303; also, Branson, D., *The Ken-Ren Case: It is an Ado where more aid is less help*, (1994) 10 *Arb.Int.* 313.

kind of delocalised procedure. In *General National Maritime Transport Co v. Götaverken Arendal AB* the Court of Appeal of Paris declined to take jurisdiction over an appeal to set aside an ICC award rendered in Paris.<sup>90</sup> The case concerned an award rendered in relation to a dispute between Götaverken a Swedish company and a Libyan company relating to contracts concluded and performed outside French territory. The court was of the view that under the ICC rules there was no compulsory supervisory role for the French courts to play ; that the case involved the interest of international commerce; that the award had not been made according to French procedural law; and that the case did not have any link with France but for the seat of arbitration (i.e. Paris) which had been chosen for its 'neutrality', and that therefore, the award was not French. Thus it could not take jurisdiction over the setting aside procedure which was available only against French awards.<sup>91</sup> This decisions came under strong criticism in France, giving as they did the impression to courts abroad that international arbitration in France was conducted under no judicial control.<sup>92</sup> That in turn could lead to the more stringent supervision applied by courts in the countries where the enforcement of awards made in France is sought.<sup>93</sup> To end the confusion, and also to promote France as an arbitration centre, the French legislature introduced the Decree of May 12, 1981 which deals specifically with "international arbitration" i.e. arbitration which "implicates international commercial interests".<sup>94</sup> According to the new legislation, parties are free to agree on the rules applicable to the procedure, in that they may subject their arbitration to any law or set of rules.<sup>95</sup> In the absence of a determination by the parties, the arbitrator "either directly or by reference to a law or a set of arbitration rules, shall establish such rules of procedure as may be necessary".<sup>96</sup> This approach of the new French law on arbitration has been construed as allowing "the

<sup>90</sup> Judgment of 9 December 1980, Cour d'appel, Paris (1981) 20 ILM 887.

<sup>91</sup> Art.11 of the ICC Rules of 1975 provides: "The rules governing the proceedings before the arbitrator shall be those resulting from these Rules and, where these Rules are silent, any rules which the parties (or, failing them, the arbitrator) may settle, and whether or not reference is thereby made to a municipal procedural law to be applied to the arbitration." 20 ILM 887 at 888.

<sup>92</sup> See Craig *et al.*, *International Chamber of Commerce Arbitration*, *supra*, note 34 at 487-88.

<sup>93</sup> *Ibid.*

<sup>94</sup> Art.1492.

<sup>95</sup> Art.1494.

<sup>96</sup> *Ibid.*

possibility of an arbitration proceeding that is essentially “non-national”.<sup>97</sup> It is to be noted that this law provides for a setting aside procedure allowing a challenge of an arbitral award rendered in an international arbitration held in France.<sup>98</sup>

The new Swiss legislation on arbitration<sup>99</sup> provides non-Swiss parties to an international arbitration held in Switzerland with the power to exclude by agreement any setting aside action before Swiss courts.<sup>100</sup> In the absence of such an agreement, the limited grounds of Art. 190, generally on due process and public policy, will apply. Parties to an international arbitration may also subject their arbitration to “the provisions of the Cantonal law relating to arbitration”<sup>101</sup> in which case there will be a much wider scope for judicial control.<sup>102</sup> Therefore, the Swiss legislature has given parties to an international arbitration, held in Switzerland, the power to choose whether or not to link their arbitration to the supervision of Swiss courts.

### 3.3.2.2 Delocalisation of Procedure and Question of Control

“When the legislature confers upon a court a given territorial jurisdiction, it is useful also to give it a seat within this territory, so that citizens know there is a judge in the neighbourhood. An arbitral tribunal manifestly has no territorial jurisdiction. Its jurisdiction is strictly personal, since it is consensual. A “seat” may thus at the most be justified by the convenience of the parties. In any event, it is by no means indispensable...”<sup>103</sup>

The quotation sums up the idea which has attracted a number of jurists. Not long ago it was the subject of heated debates<sup>104</sup> and it still catches the attention of writers.<sup>105</sup> There have been claims that international commercial arbitration can be detached from

<sup>97</sup> Craig *et al*, *supra*, note 34 at 489.

<sup>98</sup> Art. 1504.

<sup>99</sup> Private International Law Act of 1987, translation provided in Redfern, A. and Hunter, M., *Law and Practice of International Commercial Arbitration*, *supra*, note 14 at 784; general commentary Bucher, A. and P. Tschanz, *International Arbitration in Switzerland*, *supra*, note 44; also Poudret, J. F., *Challenge and Enforcement of Arbitration Awards in Switzerland*, (1988) 4 *Arbitration International* 278.

<sup>100</sup> Art. 192 *ibid.* at 788.

<sup>101</sup> Art.176(2), *ibid.* at 784.

<sup>102</sup> See for example the grounds mentioned in Art.36 of the 1967 Concordat; Commentary in Briner, R., *National Report on Arbitration:Switzerland*, In *Handbook Commercial arbitration*, *supra*, note 51.

<sup>103</sup> Paulsson, J., *The extent of independence of international arbitration from the law of the situs*, In *Contemporary problems in international arbitration*, *supra*, note 103 at 141, quoting Aubert, case note, (1958) 37 *Revue Critique de Droit international privé* 372.

<sup>104</sup> See in general Paulsson, J., *Delocalisation of international commercial arbitration: when and why it matters*, (1983) 32 *ICLQ* 53; Toope, *supra*, note 67, Chapter II.

<sup>105</sup> Toope, *Ibid.*

the law of its seat. The *lex loci arbitri* does not apply out of necessity. The choice of a place as the seat of an arbitration may be based on a variety of reasons other than any inclination to provide for the application of the procedural law of the seat. The place may have been chosen "fortuitously or for reasons of neutrality having nothing to do with the parties' attachment to local rules of arbitration."<sup>106</sup> Parties may design their own rules of procedure or decide on the application of whatever system they may consider appropriate. Alternatively, in the absence of the parties' choice or any indication by them on the question of the law applicable to procedure, the arbitral tribunal may decide on the applicable rules.

According to the proponents of the theory, the purpose of the delocalisation of arbitration is to detach the arbitral proceedings and the resulting award from the control of laws of the place of arbitration or the *lex loci arbitri*, so that there would not be any setting aside procedure available to parties to challenge the award in the country of arbitration. Furthermore, where such a setting aside procedure is available, the fact that an award has been set aside in the country of origin would not automatically mean its unenforceability in other countries.<sup>107</sup> The ruling of the courts of the country where the award is made is usually based on the peculiarities of the local law which should not affect the enforceability of the award in other jurisdictions where courts may decide on the matter according to their own laws. Therefore, the control function is shifted from the *situs* of arbitration to the country where recognition and enforcement of the award is sought.

The idea, advanced by some Western jurists, has found support in some judicial decisions and has influenced certain national legislation on international commercial arbitration. The influence of the delocalisation argument, on those national laws considered above was limited to granting more autonomy to arbitral tribunals or to giving the parties to an international arbitration the power to exclude the possibility of a challenge to the award in the courts of the place of arbitration. The Belgian and

<sup>106</sup> Paulsson, Delocalisation of international commercial arbitration, *supra*, note 104 at 54.

<sup>107</sup> Paulsson, J., The extent of independence of international arbitration from the law of the *situs*, *supra*, note 103 at 141-2.

Swiss laws have embraced the idea to a much greater extent.<sup>108</sup> As Art.1717(4) of the *Code Judiciaire* provides:

“The Belgian court can take cognize of an application to set aside only if at least one of the parties to the dispute decided in the award is either a physical person having Belgian nationality or residing in Belgium, or a legal person found in Belgium or having a branch (*une succursale*) or some seat of operation (*un siège quelconque d’opération*)”<sup>109</sup>

The effect of this Article is that there will not be any judicial review of arbitral awards rendered in arbitrations between non-Belgian parties in Belgium even if the parties have agreed to such a review. On the possible adverse results of this legislation Professor Park observes:

Under this system of ‘non-review,’ an entity that never signed the arbitration agreement (perhaps joined in the arbitration merely because of its relationship to another party) will not have a chance to litigate the arbitrator’s jurisdiction when the award is rendered. Nor would there then be an opportunity to review errors on choice of law or arbitral rules. If the parties agreed on English law to govern the contract and UNCITRAL Rules to govern procedure, the arbitrator might apply French law and AAA rules without the loser being able to challenge these defects unless the award is presented for enforcement at a later time. In this model, a legal system supports arbitration within its borders without providing minimum safeguards of basic justice.<sup>110</sup>

A challenge procedure is there to serve and uphold fundamental principles of due process of law or natural justice. The protection of the interests of an award-losing party who has been the victim of the arbitrator’s partiality or fraud may require the intervention of the courts of the place of arbitration.<sup>111</sup> Proponents of delocalisation, however, point to the courts of the place where the enforcement of the award is sought. Therefore, the “burden of control being shifted in most cases to the national legal system of the enforcement jurisdiction and then exercised only when enforcement is demanded by one of the parties. Every award for which enforcement is sought would be subject to supervision and no award of practical significance would be left floating in a general void”.<sup>112</sup> Therefore, the courts of the country of enforcement of the award would be competent to look at the irregularities which may have occurred and if

<sup>108</sup> The Swiss law, as noted above, gives the option of total delocalisation to the parties. Art. 176 of the Swiss PIL, reproduced in Redfern and Hunter, *supra*, note 14 at 784.

<sup>109</sup> Translation provided in Matray, L., National Report on Arbitration:Belgium, In *Handbook on Commercial Arbitration*, *supra*, note 51.

<sup>110</sup> Park, Judicial Control, *supra*, note 35 at 261.

<sup>111</sup> *Ibid.* at 241.

<sup>112</sup> Toope, *supra*, note 71 at 44.

substantiated, the award may be denied recognition and enforcement.<sup>113</sup>

This argument does not appear convincing on several grounds. The proper operation of the New York Convention regime, as the main convention in the field, requires the exercise of control by the "primary-secondary jurisdictions" i.e. the place of arbitration and the country where the recognition and enforcement of the arbitral award is sought.<sup>114</sup> It would be wrong to assume that the necessary level of control could be exercised only by the courts of the place of enforcement.<sup>115</sup> The *ex post facto* control of arbitration in the country where enforcement is sought is only concerned with the requirement of "international currency" of the awards.<sup>116</sup> This level of control may prove inadequate. The grounds of refusal of recognition and enforcement of an award may not include an irregularity which occurred in the country of origin of the award, therefore the victim of such an irregularity may be left with no forum to take his action before. In response, it may be argued that recognition and enforcement of such an award may always be challenged on the ground of being contrary to the public policy of the enforcement country. This may not necessarily be the case. Because what a local court understands as public policy-based grounds refusal of recognition and enforcement may not cover the alleged irregularities of the award. For example, one concern of the Departmental Advisory Committee on Arbitration law was that the adoption of the Model Law in England would leave challenge of an award tainted with the misconduct of the arbitral tribunal impossible as such situations are not covered by the grounds for setting aside awards of the Model Law and there is no developed general doctrine of public policy in common law countries in relation to arbitration

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<sup>113</sup>*Ibid.*

<sup>114</sup>Reisman, *Systems of Control*, *supra*, note 5 at 116-7.

<sup>115</sup>On possible adverse results of the elimination of the controlling role of the primary jurisdiction- place where arbitration takes place, he maintains: "Without the primary-secondary jurisdictional distinction, all state parties to the New York Convention would be jurisdictionally equal. If any of the almost eighty fora of the convention enjoyed the power accorded to primary jurisdictions, the unscrupulous arbitration loser could quickly abandon the neutral forum which both parties had agreed and seek a favourably inclined jurisdiction. He could secure a full "nullification" there and then use it as a defence to enforcement in all other fora." *Ibid.*

<sup>116</sup>Craig, *Use and Abuse of Appeal*, *supra*, note 10 at 183. He further argues that shifting all the control function to place of enforcement increases the chances that the control function will be exercised by a court sharing the nationality of one of the parties. This, in turn, could raise the likelihood of objections that the review may be suspected of bias or the appearance of bias. *Ibid.* at 202.

procedure.<sup>117</sup>

Furthermore, in response to the claim of the existence of some universal standards of public policy, it was noted earlier,<sup>118</sup> that there is no truly international public policy; international public policy of a state is part of its national public policy applicable to cases with an international element. Public policy by definition is relative to time and place and courts in a heterogeneous world follow different concepts of public policy.<sup>119</sup> An irregularity may be seen as a public policy ground for not granting recognition by courts of one country and not by those of another.<sup>120</sup> Furthermore, the court's role in refusing recognition and enforcement may involve a discretion which it may choose not to exercise.<sup>121</sup>

In the absence of a challenge procedure in the country of origin, an award-losing party, faced with an award tainted with serious irregularity or fraud will have to wait for the award winning-party, who may be the beneficiary of the irregularity, to choose the country of enforcement so that the action to challenge the award in the courts of that country can be brought. Even if the challenge is successful, it will not be the end of the story. The award has to be challenged in any country its recognition and enforcement is sought.<sup>122</sup> Furthermore, if there is no attempt by the award-winning

<sup>117</sup> The UNCITRAL Model Law on Arbitration, A Consultative Document, Departmental Advisory Committee on Arbitration Law and Scottish Advisory Committee on Arbitration Law 1987, 36.

<sup>118</sup> See chapter II, *supra*, 2.5.1.1.

<sup>119</sup> Paulsson seems to be of a different view when he finds the application of uniform standards of public policy a possible solution: "only as an instrument for the control of the conformity of the award to transnational minimum standards such as those embodied in the major international conventions. Unless the parties have agreed otherwise, [the judge at the place of arbitration] has no mission or capacity to apply his own national criteria to the award." Paulsson, *Arbitration Unbound*, *supra*, note 107 at 370.

<sup>120</sup> The standard of public policy may change over the time in the same country. For example, the application of the "manifest disregard" standard has relaxed in the United States making it impossible to challenge awards on procedural grounds. Sever, J., *The relaxation of inarbitrability and public policy checks on US and foreign arbitration: arbitration out of control?*, (1991) 65 *Tulane Law Review* 1661 at 1963.

<sup>121</sup> E.g. Art.V of the New York Convention which gives the courts a discretion whether or not refuse recognition and enforcement on the grounds set forth in the Article including public policy.

<sup>122</sup> Van den berg elaborating the problem in the following words:

"An elimination of the ground for refusal that the award has been set aside in the country of origin would, in my opinion, be undesirable. A losing party must be afforded the right to have the validity of the award finally adjudicated in one jurisdiction. If that were not the case, in the event of a questionable award, a losing party could be pursued by a claimant with enforcement actions from country to country until a court is found, if any, which grants the enforcement. A claimant would obviously refrain from doing this if the award has been set aside in the country of origin and this is a ground for refusal of enforcement in other Contracting States." *The New York Convention: Towards a Uniform Judicial Interpretation*, The Hague: T.M.C. Asser Institute 1981, 335.

party to have the award enforced there will not be any opportunity for the award-losing party to challenge it. There could be good reasons for obtaining an award other than pursuing its enforcement such as obtaining a strong bargaining position in negotiations on compensation, or its production in support of a claim brought before national export guarantee funds. Moreover, such an award can always have adverse publicity effects on the award-losing party.

Proponents of the delocalisation theory follow a contractualist approach according to which, being the creation of parties' will, arbitration should be conducted free from the law of the place where it is held. The idea ignores the interest of the state of the locus of arbitration in upholding principles of due process or natural justice. Those legislations providing for the possibility of total delocalisation of arbitration where motivated by extra-legal considerations which, if followed by other national laws, would seriously undermine the institution of international commercial arbitration:

"As we have seen, the English and French adjustments were well within the range of collaborative control requirements expected of parties to the New York Convention. In my view the Belgian and Swiss legislative experiments are not. As long as a very limited number of states follow the Belgian example, the aggregate consequences for the international arbitration system will be contained. The "Belgians," as it were, will take advantage of the more stringent jurisdictional practices of other jurisdictions to attract a quantity of arbitral business that would otherwise not have selected their venue. They are free riders, in the economic sense, benefiting from a general regime but refusing to pay their dues. They are, in this sense, engaging in an unfair trade practice by exploiting a noneconomic variable in order to make themselves more attractive to a class of potential consumers of services.<sup>123</sup>

It should be noted, however, that complete delocalisation remains an exception; the majority of national laws, including most new legislation on arbitration, provide for a degree of control by the courts of the place of arbitration.

As mentioned in the beginning of the chapter, the primary concern of the state party in the dispute settlement process is respect for its sovereign prerogatives regarding the contract. On the question arbitration as an appropriate method of state contracts dispute settlement, it was already noted that, judicial control may play an important role; arbitral tribunals which are subject to judicial control are more likely to give effect to the public policy limitations of arbitrability of state contracts as required by the public interest demand.<sup>124</sup> Judicial control, as will be noted in chapter IV, may be also

<sup>123</sup> Reisman, *Systems of Control*, *supra*, note 5 at 131.

<sup>124</sup> See, in general, Ch. II, *supra*, 2.5.2.

relevant in the arbitrator's determination of the applicable substantive in that arbitrations which are judicially bound are more likely to give effect to public policy requirements of the state party based in its law.<sup>125</sup> This, in turn, would exclude the applicability of certain substantive remedies against the state party to the contract.<sup>126</sup> Since in delocalised arbitrations, there is a strong possibility for the arbitral tribunal to effectively ignore the public policy requirements of the relevant laws including that of the place of arbitration, such arbitrations are less compatible with the interests of the state party to the dispute.

In the context of state contracts, *ad hoc* arbitral tribunals have mentioned additional reasons for not applying the law of the place of arbitration. The *Aramco case* related to a dispute about the exclusive right to transport oil under an agreement between the Government of Saudi Arabia and the Arabian American Oil Company.<sup>127</sup> Aramco claimed that another agreement between the Government and the Saudi Arabian Maritime Tankers Ltd., according to which the latter would have the priority right for the transport of Saudi Arabian oil, was in violation of the Concession agreement between the Government and Aramco. The parties submitted the dispute to arbitration in Geneva. The tribunal on the matter of procedure chose not to apply the law of its seat, on the basis of what it saw as a consideration of sovereign immunity of states, and instead applied international law:

Considering the jurisdictional immunity of foreign states, recognised by international Law in a spirit of respect for the essential dignity of sovereign power, the Tribunal is unable to hold that arbitral proceedings to which a sovereign State is a Party could be subject to the law of another State. Any interference by the latter State would constitute an infringement of the prerogatives of the State which is a Party to the arbitration. This would render illusory the award given in such circumstances. For these reasons, the Tribunal finds that the law of Geneva cannot be applied to the present arbitration. It follows that the arbitration, as such, can only be governed by International law...<sup>128</sup>

Arbitral tribunals in *Texaco* and *LIAMCO* also refused, on different grounds, to apply the law of the place of arbitration to the procedure. For the sole arbitrator Dupuy together with the Aramco's 'respect for sovereignty argument', the procedure set out by the parties for the appointment of a sole arbitrator by the President of the

<sup>125</sup> See, in general, Ch. IV.

<sup>126</sup> See, in general, Ch. V.

<sup>127</sup> *Aramco*, Award of 23 August 1958, 27 ILR 117.

<sup>128</sup> *Ibid.* at 155-156.

International Court of Justice was an indication of the implied intention of the parties to have any possible arbitration between them governed by international law.<sup>129</sup> As for the sole arbitrator in *LIAMCO*, there was an accepted principle of international law that arbitral rules of procedure shall be determined by the agreement of the parties. In the absence of such an agreement, the arbitral tribunal could decide on the procedure "independently of the local law of the seat of arbitration."<sup>130</sup> On this basis, the sole arbitrator chose to apply the UN Draft Convention of Arbitral Procedure adopted by the International Law Commission.<sup>131</sup>

The validity of sovereign immunity considerations as a ground for delocalisation of arbitration is open to question. Under international law states may validly waive their immunity by consent.<sup>132</sup> Many national laws consider a submission to arbitration as an implied waiver of immunity from jurisdiction of courts in proceeding concerning the conduct of arbitration.<sup>133</sup> Once a state has agreed to arbitration, the prevailing position is that immunity could not be pleaded with regard to certain powers of courts concerning arbitration including matters relating to judicial control of the proceeding.<sup>134</sup>

Furthermore, the above cases may not be considered as supportive of the kind of delocalisation advocated by proponents of delocalisation of international commercial arbitration. When an arbitration is procedurally governed by international law, the control mechanism of that law will operate, and thus the source of control is clear- though not the relevant rules- whereas in the case of a delocalised international commercial arbitration it may be not as clear.

<sup>129</sup>*Texaco Overseas Petroleum Company and California Asiatic Oil Company v. The Libyan Arab Republic*, Awards of 27 November 1975 and 19 January 1977 (Merits), 53 ILR 389 at 431-436.

<sup>130</sup>*Libyan American Oil Company (LIAMCO) v. the Government of the Libyan Arab Republic*, 62 ILR 140 at 180.

<sup>131</sup>*Ibid.*

<sup>132</sup> See Chapter II, *supra*, 2.5.4.

<sup>133</sup> *Ibid.* at 2.5.4.1.

<sup>134</sup> Considering the fact that for sovereign immunity reasons states are not usually willing to appear before foreign courts, it may be argued that states do not favour national courts's control on arbitration. A distinction should be made between the case where a state is sought to be a party to a court litigation and the situation where a state uses a national court's intervention to challenge an improper ruling of an arbitral tribunal on its jurisdiction or other violations of fundamental procedural rights. In the latter kind, the court would only deal with some procedural matters without going into the merits of the dispute. It seems that such court interventions may be in the interest of the state party and not in violation of its sovereign immunity.

### 3.4 Control Function in Institutional Arbitrations

The preceding part of this chapter addressed the question of the control function in international commercial arbitration, with specific reference to arbitration of state contracts. It was noted that the control function role in such arbitrations, in principle, is played by the law of the place of arbitration. In this part, control functions of three arbitration institutions is studied: ICSID arbitration, a procedurally detached arbitration, which was created by a multilateral convention with the aim of providing a depoliticised kind of arbitration specifically dealing with investment disputes; the Iran-US Claims Tribunal, an international tribunal established following a bilateral agreement between the two states providing for the settlement of, among others, state contract disputes; and the International Chamber of Commerce which is one of the most-often-utilised arbitration institutions by the international business community and is claimed to suit all kinds of disputes including state contracts disputes.<sup>135</sup> The ICC as a private institution is largely devoted to the cause of promotion of a 'transnational' model of arbitration i.e. arbitrations free from the intervention of national laws.<sup>136</sup>

#### 3.4.1 ICSID

The Washington Convention of 1965 provides for an essentially self-contained dispute settlement machinery, detached from the law of the place of arbitration.<sup>137</sup> According to the ICSID Rules of Procedure<sup>138</sup> ICSID arbitrations are governed by the agreement of the parties, the Rules, and, in the case of any gap, by the decision of the arbitral tribunal on the matter.<sup>139</sup> The ICSID Convention and its Rules of Procedure exclude any recourse to national courts of contracting states in order to challenge the procedure of arbitration or the award. ICSID awards "shall be binding on the parties and shall not be subject to appeal or any other remedy except those provided for in the

<sup>135</sup> See, Craig *et al.*, *International Chamber of Commerce Arbitration*, *supra*, note 34 at 664.

<sup>136</sup> See Ch. I, *supra*, 1.3.3.

<sup>137</sup> Exceptions being those concerning the execution of awards where the assistance of local courts is needed. See Ch. VI, *infra*, 6.2.3.

<sup>138</sup> Rules of Procedure for the Institution of Conciliation and Arbitration Proceedings, reproduced in Redfern and Hunter, *supra*, note 14 at 595.

<sup>139</sup> Art.44 of the Convention.

Convention."<sup>140</sup> Each contracting party must recognise an ICSID award as binding and enforce the pecuniary obligations of the award in the same way as a final judgment of a court of that State.<sup>141</sup>

The remedies provided by the Convention are interpretation, revision and annulment which should be sought exclusively through the procedure governed by the Convention. Interpretation is a remedy available in cases where there is a disagreement between the parties as to the meaning and scope of the award.<sup>142</sup> It should be sought primarily before the tribunal which originally dealt with the case and rendered the award. Revision is concerned with the "discovery of some facts of such a nature as decisively to affect the award, provided that when the award was rendered that fact was unknown to the Tribunal and to the applicant and that the applicant's ignorance was not due to negligence"<sup>143</sup> There is a time limit of 90 days after the discovery of such facts, and, in any events application for revision must be filed within three years of the date of the award.<sup>144</sup>

Annulment differs both from interpretation which does not undermine the finality of the award, and from revision which impairs the finality of the awards for reasons outside the arbitral proceedings, namely, discovery of new facts unknown in the course of proceedings.<sup>145</sup> Annulment relates to the arbitral proceedings. Grounds upon which it can be invoked include the improper constitution of the tribunal; that the tribunal acted in excess of power; corruption; lack of due process and the handing down of an unreasoned award.<sup>146</sup> The annulment process should be distinguished from an appeal; it does not involve the review of the merits of the award and possibly its subsequent reformation.<sup>147</sup> A request for annulment should be addressed to the Secretary-General of the Centre who then would request the Chairman of the

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<sup>140</sup> Art. 53(1) of the Convention.

<sup>141</sup> Art.54 of the Convention.

<sup>142</sup> Art.50.

<sup>143</sup> Art. 51(1).

<sup>144</sup> Art. 51(2)

<sup>145</sup> See Broches, A., *supra*, note 5 at 324.

<sup>146</sup> Art.50 of Rules of Procedure; Also Art. 52(1) of the Convention .

<sup>147</sup> Broches, Observations on the Finality of ICSID Awards, (1991) 6 ICSID Rev.-FILJ 321 at 325.

administrative Council to appoint an *ad hoc* committee to deal with the application.<sup>148</sup>

It is clear that the drafters of the Convention, while not intending to include an appeal procedure in the Convention, felt the need to ensure the legality of the arbitral process and awards within the framework of the Convention. In principle, Art.52 addresses the problems of departure from fundamental rules of procedure, excess of power and fraud. There have been a number of requests for annulment, some of which led to the establishment of *ad hoc* annulment committees which resulted in the annulment of awards.<sup>149</sup> Such decisions have been the subject of strong criticism for undermining the popularity of ICSID arbitration as a means of settling investment disputes.<sup>150</sup> Below a brief account of such decisions and some of the major criticism they have attracted is given.

The *Klöckner* case concerned a dispute arising out of a joint venture contract for the construction of a fertiliser factory in Cameroon between Klöckner and the Government of Cameroon.<sup>151</sup> Klöckner was to supply and erect the factory and manage it for at least five years and the Government was to provide the site and guarantee loans arranged by Klöckner. After a period of unprofitable operation the factory was shut down. Klöckner initiated arbitration to recover the unpaid balance of the purchase price and the Government counterclaimed for losses resulting from Klöckner's failure of contractual performance. The arbitral Tribunal, presided over by Eduardo Jimenez de Aréchaga, rendered an award declaring the cancellation of the Cameroonian debt to Klöckner because of the latter's failure to perform its contractual obligations. On the question of applicable law, in the absence of an agreement thereon, the Tribunal following Art.42 of the Convention decided that the law of the State party

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<sup>148</sup> Art.52.

<sup>149</sup> *Klöckner v. Cameroon*, Annulment decision of May 3 1986, (1986) 1 ICSID Rev-FILJ. 89; *Amco Asia v. Indonesia*, Annulment decision of 16 May 1986, (1986) 25 ILM 1439; *Mine v. Guinea*, Partial Annulment decision of 22 December 1989, (1990) 5 ICSID Rev-FILJ 95.

<sup>150</sup> Reisman, M., *Repairing ICSID's Control System: Some Comments on Aron Broches "Observations on the Finality of ICSID Awards"*, *supra*, note 1; Feldman, M., *The Annulment Proceedings and the Finality of ICSID Arbitral Awards*, (1987) 2 ICSID Rev-FILJ 85; Redfern, A., *ICSID- Losing its Appeal?*, (1987) 3 Arb.Int. 98.

<sup>151</sup> ICSID Award of October 21, 1983 in Case no.ARB/81/2 *Klöckner Industrie-Anlagen GmbH v. United Republic of Cameroon*, 1983, reprinted in (1985) X YBCA 71; Commentary see Paulsson, J., *The ICSID Klöckner v. Cameroon Award: The duties of partners in North-South economic development agreements*, (1984) 1 J. Int. Arb. 145.

i.e. Cameroon was applicable, more specifically the law of the eastern part of the country which was based on French law. Consequently, the Tribunal decided the case on the basis of two principles of French law and of those systems known to the Tribunal, a duty of disclosure to a partner and the *exceptio non adimpleti contractus* - a civil law concept similar to "the common law right of non-performance."<sup>152</sup> On the first principle the Tribunal said:

We take for granted that the principle according to which a person who engages in close contractual relations, based on confidence, must deal with its partner in a frank, loyal and candid manner is a *basic principle of French civil law*, as is indeed the case under the *other national codes that we know of...* In the present case, as we suggested, we do not feel that Klöckner has dealt frankly with Cameroon.<sup>153</sup> (Italic supplied)

The Tribunal did not go further into identifying the origin of the principle in French law. On the second principle, *exceptio non adimpleti contractus* the Tribunal invoked general principles under French, English and international law citing a number of cases and authorities.<sup>154</sup> The Tribunal decided that the money already paid by the Government compensated the partial performance by Klöckner.<sup>155</sup> Dissatisfied with the award, Klöckner initiated annulment proceedings.<sup>156</sup> The *ad hoc* Committee presided over by Professor P. Lalive annulled the award on two grounds, namely that the arbitral Tribunal had failed to apply the correct law and in that had exceeded its power, and that it had failed to give reasons for the award.<sup>157</sup> On the question of the applicable law the Committee said that "in the absence of any information, evidence or citation in the Award, it would seem difficult to accept, and impossible to presume, that there is a general duty, under French civil law, or for that matter other systems of civil law, for a contracting party to make a "full disclosure" to its partner."<sup>158</sup> The *ad hoc*

<sup>152</sup> Feldman, *The Annulment Proceedings and the Finality of ICSID Arbitral Awards*, *supra*, note 150 at 92.

<sup>153</sup> Paulsson, *supra*, note 151 at 157.

<sup>154</sup> *Ibid.* at 159.

<sup>155</sup> *Ibid.*

<sup>156</sup> *Klöckner Industrie-Anlagen GmbH v. United Republic of Cameroon* (Annulment Decision of the *Ad Hoc* Committee, 1985, reprinted in (1986) XI YBCA 162 at 162-163. Klöckner argued excess of power, departure from fundamental rule of procedure and failure to give reasons by arbitral tribunal as ground for its request for annulment. *Ibid.*

<sup>157</sup> *Ibid.* at 171-173.

<sup>158</sup> *Ibid.* On the second ground of annulment (i.e. failure to state reasons) the *ad hoc* Committee noted that there were no reasons mentioned for various conclusions of the Tribunal on which the award was based. This was contrary to provisions of Art.48(3) of the ICSID Convention which, in the view of the *ad hoc* Committee, would give rise to a ground for annulment.

Committee concluded that the Tribunal had not applied French law and had acted as *amiabile compositeur* with no authorisation from the parties and therefore had manifestly exceeded its powers within the meaning of Art. 52(1)(b) of the Convention.<sup>159</sup>

Therefore, the violation of provisions of Art.42 of the Convention relating to the question of the law applicable to the substance of the dispute was considered by the *ad hoc* Committee as an instance of excess of power. The Committee emphasised the “fine distinction between the ‘non-application’ of the applicable law and mistaken application of such law” and found that the case was one of the former kind<sup>160</sup> which would be a ground for annulment. Failure to state reasons for the award was the second ground on which the annulment of the award was based. In its interpretation of Art.52(1)(e), the *ad hoc* Committee closely examined different forms of failure to state reasons in the award including where the given reasons are not “sufficiently relevant” to the conclusions drawn by the Tribunal.<sup>161</sup> The Committee considered that failure to deal with the questions submitted to the Tribunal were covered by Art.52(1)(e) and a ground for annulment.<sup>162</sup>

Such an interpretation and close examination of Art.52 by the Committee has made some commentators question the future of ICSID arbitrations:

Would this decision lead other *ad hoc* Committees established under Article 52 to annul awards that they deemed inadequately founded in law or fact? If so, ICSID arbitration could degenerate into an inconclusive battle of views between strong-willed arbitrators on matters easily susceptible of disagreement?<sup>163</sup>

Broches maintains that the Committee went beyond the drafter’s conception of annulment “as an exceptional remedy and substituted its own “correct” interpretation which involved, in particular, the right of an *ad hoc* Committee to judge the quality of reasoning of the Tribunal, moving to prohibited role of an appellate tribunal.”<sup>164</sup>

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<sup>159</sup> *Ibid.* at 173.

<sup>160</sup> Klöckner Decision, in Paulsson, *supra*, note 151 at 167-173.

<sup>161</sup> *Ibid.* at 174-182.

<sup>162</sup> *Ibid.* at 179-183.

<sup>163</sup> Feldman, M., The Annulment Proceedings and the Finality of ICSID Arbitral Awards, *supra*, note 150 at 94; Also see Berger, K. P., The International Arbitrators’ Application of Precedents, (1992) 9 *Journal of International Arbitration* 5 at 18-19.

<sup>164</sup> Broches, Observations on the Finality, *supra*, note 147 at 377.

In *Amco Asia v. Indonesia* the dispute related to an agreement for the construction and management of a Hotel in Djakarta.<sup>165</sup> Upon completion of the Hotel, a dispute arose regarding its management. The owner, an organisation linked to the Indonesian Army, sought to discontinue Amco's involvement in the management. Subsequently, the Indonesian Government revoked the investment licence and the Army took control of the premises. Amco initiated arbitration. The arbitral tribunal presided over by Professor Goldman held that the intervention of the Army was an international wrong attributable to the Government and that Indonesia was liable for the unlawful withdrawal of the investment licence having violated both Indonesian and international law.<sup>166</sup> Indonesia sought annulment of the award.<sup>167</sup> The *ad hoc* Committee presided over by Professor Seidl-Hovenfeldern unanimously annulled the award on the grounds that the Tribunal, in rendering the award had failed to apply the applicable law (i.e. Indonesian law) which would have resulted in a different conclusion and therefore had exceeded its power.<sup>168</sup> The Committee held that according to Art.42(1) an ICSID tribunal is authorised to apply "rules of international law only to fill up *lacuna* in the applicable domestic law and to ensure precedence to international law norms where the rules of the applicable domestic law are in collision with such norms"<sup>169</sup> Furthermore, the award had failed to state reasons indicating the "connection between the bases invoked by the Tribunal and the conclusions reached by it."<sup>170</sup>

The decisions in *Klöckner* and *Amco* were strongly criticised by commentators on various grounds, particularly concerning the future efficiency of ICSID process.<sup>171</sup> The *ad hoc* Committee in a further case entered its decision, having considered those criticisms. In *MINE* the Government party sought annulment of an ICSID award on the ground, among others, that the arbitral Tribunal had not applied the proper law of contract or indeed that it had not applied any law and in that it had accordingly

<sup>165</sup> Award of November 21, 1984 (1985) 24 ILM 1022.

<sup>166</sup> *Ibid.* at 1033.

<sup>167</sup> Decision of the *Ad Hoc* Committee Setting Aside the Award Rendered on the Merits, May 16, 1986, reprinted in (1987) 12 YBCA 129 at 131; also produced in (1986) 25 ILM 1439 at paras 92-95.

<sup>168</sup> (1987) 12 YBCA at 132-4.

<sup>169</sup> *Ibid.*

<sup>170</sup> *Ibid.* at 143-147.

<sup>171</sup> *Supra*, note 150.

exceeded its power.<sup>172</sup> The *ad hoc* Committee, having emphasised that only disregard for the applicable law as distinct from misapplication of it would be a ground for the annulment, did not agree with the government of Guinea's assertion that the Tribunal had not applied any law.<sup>173</sup> It stated:

Admittedly, the Tribunal erred in citing Article 1134 of the French Civil Code. The Committee notes, however, that the relevant provision of the applicable Guinean law is contained in the "Code Civil de l'Union Francaise" with the same number and the same contents as Art. 1134 of the French Civil Code. For this reason, the Committee does not consider that this error warrants annulment.<sup>174</sup>

The *ad hoc* Committee, however, partially annulled the award on the ground of failure to state reasons and failure to deal with questions submitted to the Tribunal.<sup>175</sup> According to Article 48(3) of the Convention an award should "deal with every question submitted to the Tribunal". Art.49(2) of the Convention permits a tribunal "to decide any question it had omitted to decide in the award". The Committee made a distinction between cases where a tribunal fails to exercise jurisdiction in full by not addressing all the questions which could be remedied by supplementing the award<sup>176</sup> and cases of failure to state reason which call for annulment.<sup>177</sup> The Committee decided that in light of several violations of Art.48(3) it was compelled to annul the portion of the award relating to damages.<sup>178</sup> The decision has been criticised as adding two new grounds to those already contained in the Art.52 of the Convention i.e. failure of the award to deal with every argument raised by the parties and that the award was based on contradictory reasons.<sup>179</sup> It is further argued that these additional grounds "suffer from a risk of subjective application."<sup>180</sup>

The *ad hoc* Committee in *MINE* tried to present a less liberal interpretation of

<sup>172</sup> Decision of the *ad hoc* Committee, (1990) 5 ICSID Rev.-FILJ 95 at 103. Guinea also contended grounds (b) & (e) of Art.52(1) i.e. 'departure from fundamental rule of procedure' and 'failure to state reasons'. Commentary Sturzenegger, M., ICSID Arbitration and Annulment for Failure to State Reasons- The Decision of the *Ad Hoc* Committee in *Maritime International Nominees Establishment v. The Republic of Guinea*, (1992) 9 Journal of International Arbitration 173.

<sup>173</sup> Decision of the *ad hoc* Committee, *ibid.* at 111-113.

<sup>174</sup> *Ibid.*

<sup>175</sup> *Ibid.* at 126.

<sup>176</sup> Art.49(2) of the Convention.

<sup>177</sup> *Ibid.* at 104-5.

<sup>178</sup> *Ibid.* at 124-126.

<sup>179</sup> Sturzenegger, *supra*, note 172 at 196.

<sup>180</sup> *Ibid.*

grounds for annulment of Art.52(1), and, in so doing, to accommodate some of the criticisms made against the *Klöckner* and *Amco* decisions. One concern expressed over the earlier decisions was the automatic nature of the process upon finding a ground for annulment which has been described as a 'hair-triggered' mechanism.<sup>181</sup> The mere existence of one of the grounds of Art.52(1) might be sufficient for the Committee to annul the award regardless of the effect that such a ground may or may not have had on the procedure or the award.<sup>182</sup> On this, the Committee in *MINE* took the view that it should be up to the Committee to decide not to annul the award "where annulment is clearly not required to remedy procedural injustice and annulment would unjustifiably erode the binding force and finality of ICSID awards."<sup>183</sup>

Another objection to the decisions in *Klöckner* and *Amco* was to their broad interpretation of 'failure to state reasons' which in effect could lead to the Committee acting as an appellate body. This ground was interpreted in a narrower sense by the *MINE* Committee. For the Committee an award would be sufficiently reasoned when it "enable[s] one to follow how the tribunal proceeded from point A to point B, and eventually to its conclusion, even if it made an error of fact or law."<sup>184</sup>

From the study of the provisions of the ICSID Convention and its case law, it would appear that the need for control over the procedure of arbitration, especially in highly sensitive contracts, such as those falling within the jurisdiction of ICSID arbitral tribunals, had been realised by the drafters of the Convention. A built-in control mechanism was developed and put on trial. In the process, a broad interpretation of the grounds for annulment was found unsatisfactory and gave its place to a more restrictive one. However different in their approach, the decisions of the *ad hoc* Committees highlighted some of the fundamental issues regarding the question of control in arbitration of state contracts.

Feldman observes that the decisions of the *ad hoc* Committees indicate that "ICSID

<sup>181</sup> Reisman, M., *The Breakdown of the Control Mechanism in ICSID Arbitration*, (1989) Duke L.J. 739, at 762.

<sup>182</sup> *Ibid.*

<sup>183</sup> *MINE* Decision, *supra*, note 166, para. 4.09.

<sup>184</sup> *Ibid.* paras. 5.08-5.09.

arbitration is a process of adjudication under law” in that matters such as the application of the proper law by the arbitral tribunal and its reasoning of the award will be subject to close examination which could lead to the review of the award on its merits a practice contrary to “the trend in modern arbitration practice.”<sup>185</sup> It is true that in some cases it could prove difficult to draw the line between the reviewing ‘procedural legitimacy’ of an award against the background of Art.52(1) and the merits of the award. All *ad hoc* Committees were emphatic on the principle of the non-reviewability of the merits regardless of the difficulties involved. It is the importance of the role that the control mechanism of the Convention plays in relation to the expectation of both sides that makes that mechanism indispensable. The quality of one of the parties to arbitration (a state or a state entity), and the underlying legal relationship (an investment agreement) makes such arbitrations highly sensitive.<sup>186</sup> ‘Finality’, unlike in private arbitrations, may not be the paramount concern of a state party in the arbitration of its disputes. It is representing a country where the national interest is at stake, and for that it may be accountable to various bodies in its home country. Therefore such a party is under more pressure to try all the possible avenues in safeguarding the protection of the public interest through a legal arbitral process. It is not only in the interest of the state party, but that of the international community at large to ensure legality and fairness in the ICSID arbitral process rather than merely the speedy and final resolution of disputes concerned. The protection of parties’ interest, some argue, may even require that “substantive correctness” of the award be examined, a kind of review much closer to what an appellate tribunal does than an *ad hoc* annulment committee.<sup>187</sup>

<sup>185</sup> Feldman, *supra*, note 150 at 97.

<sup>186</sup> Caron expresses some doubt as to whether even in private arbitrations when the amount in dispute is quite high, the parties are inclined not to have their dispute adjudicated “with only one roll of the die”. Caron, *supra*, note 18 at 49.

<sup>187</sup> *Ibid.* at 51. Lauterpacht Maintains: “It is strongly arguable that cases are better decided by judges of experience than by arbitrators selected *ad hoc* for the purposes of a single case. Arbitration however is an important component of the international system and cannot be done away with. We should contemplate the possibility that its value may be enhanced if it is linked to a system of appeal. *Aspects of Administration of International Justice*, *supra*, note 7 at 112.

### 3.4.2 Iran-US Claims Tribunal

In order to settle outstanding disputes between the two countries and to facilitate the ending of a crisis<sup>188</sup> existing at the time, in January 1981, Iran and the United States entered into a series of agreements.<sup>189</sup> One of these, the Claims Settlement Agreement, provided for the establishment of an international tribunal to deal, among other things, with the "claims of nationals of the United States against Iran and claims of nationals of Iran against the United States, and any counterclaims which arise out of the same contract, transaction or occurrence that constitute the subject matter of that national's claim arising out of debts, contracts (including transactions which are the subject of letters of credits or bank guarantees), expropriations or other measures affecting property rights..."<sup>190</sup>

The Tribunal consists of three chambers each including one party-appointed arbitrator and a neutral arbitrator as the president.<sup>191</sup> The procedure of the Tribunal is governed by the UNCITRAL Arbitration Rules as modified by the parties and the Tribunal.<sup>192</sup> The Tribunal may conduct the arbitration in such a manner as it considers appropriate, provided that the parties are treated equally and are given a full opportunity to present their claims.<sup>193</sup> All decisions and awards of the Tribunal are final and binding and enforceable in the courts of any nation in accordance with its laws.<sup>194</sup> The Rules do not contain provisions for challenge on grounds such as excess of powers, violation of fundamental principles of procedure or fraud which if proven would have the appropriate remedy of rendering the award a nullity. The reason for

<sup>188</sup> For a brief study of the historical background of the Iran-US economic interactions, their political underpinnings and their effects on the underlying circumstances of establishment of the Tribunal see Vafakish Sistani, M., Claims Tribunals with specific reference to the Iran-US Claims Tribunal (unpublished paper), presented in the Centre for Studies and Research in International Law and International Relations, The Hague Academy of International Law, 1987.

<sup>189</sup> The agreements known as Algiers Accords include two declarations and some technical agreements; The Declaration of the Government of the Democratic and Popular Republic of Algeria Relating to the Commitments Made by Iran and the United States (The General Declaration), reprinted in 20 ILM, 223; Undertaking of the Governments of Iran and United States (The Undertaking), *Ibid.* at 229; The Declaration of the Government of Algeria Concerning the Settlement of Claims by Iran and the United States (The Claims Settlement Agreement) *Ibid.* at 230 and the Escrow Agreement, *Ibid.* at 234.

<sup>190</sup> Art.II (1) of the Claims Settlement Agreement.

<sup>191</sup> *Ibid.* Art.III (1)

<sup>192</sup> *Ibid.*, Art. III (2); Text of the Tribunal Rules reprinted in 2 Iran-US CTR 405.

<sup>193</sup> Art.15 of the Rules of the Tribunal.

<sup>194</sup> Art.V (1) & (3) of the Claims Settlement Agreement.

this silence is that the Rules were originally designed to cover *ad hoc* international commercial arbitrations which are normally national arbitrations subject to the law of the place of arbitration. It is that law which provides for procedural remedies against serious improprieties in the proceedings of arbitration and awards. Here the question arises as to the nationality of the Iran-US Arbitration. To answer the question, one has to examine the nature of the Tribunal. Is it a private arbitration rendering the procedure and the ensuing awards Dutch? If so, the Tribunal's awards would be susceptible to challenge in the courts of the Netherlands. Or is the Tribunal a public international law one where procedural remedies should be sought in international law ?

Opinion has been divided on the nature of the tribunal.<sup>195</sup> Some commentators have considered it an international claims tribunal similar to mixed claims commissions charged with the adjudication of interstate claims based on the claims of their nationals to diplomatic protection.<sup>196</sup> Others have pointed to the hybrid nature of the Tribunal in the light of the types of claims involved.<sup>197</sup> The issue of the nature of the Tribunal and its relevance to the question of procedural remedies attracted a good deal of attention when Iran attempted to challenge the validity of a number of the Tribunal's awards in the Dutch courts on the ground of the non-participation of the Iranian arbitrators in the deliberations of the cases which, under the Dutch Code of Procedure (Art.649(3)) was a ground for setting aside an award.

During the course of challenge proceedings, a Bill was proposed to the Dutch Parliament addressing the question of the applicability of Dutch law to the Tribunal's awards.<sup>198</sup> The Bill differentiated between the awards rendered in relation to claims of nationals of each state against the other states and awards rendered in relation to

<sup>195</sup> See Lloyd Jones, D., *The Iran-US Claims Tribunals: Private Rights and State Responsibility*, In *Iran-United States Claims Tribunals*, Edited by R. Lillich, 50.; Lake and Tucker, *Judicial Review of the Iran-US Claims Tribunal: Are the Tribunal's Awards Dutch?*, (1984) 16 *Law and Policy in International Business* 755; Caron, *The Nature of the Iran-United States Claims Tribunal and the Evolving Structure of International Dispute Resolution*, (1990) 84 *AJIL* 104; Seifi, J., *Procedural Remedies against Awards of Iran-United States Claims Tribunal*, (1992) 8 *Arbitration International* 41-; Toope, *supra*, note 67 at 265-292; Amerasinghe, C. F., *Book Review- Mixed International Arbitrations: Studies in Arbitration Between States and Private Persons* by S.J.Toope, (1992) 7 *ICSID Review* 290.

<sup>196</sup> Amerasinghe, *ibid.*; Gray, C., *Judicial Remedies in International Law*, Oxford:Clarendon Press. 2d edition 1990, at ; Fox, H., *States and Undertaking to Arbitrate*, (1988) 37 *ICLQ* 1 at 3.

<sup>197</sup> See Lloyd Jones, *supra*, note 188.

<sup>198</sup> The Bill Regarding the Applicability of Dutch Law to the Awards of the Tribunal Sitting in the Hague to Hear Claims Between Iran and the United States, translation reprinted in 4 *Iran-US CTR.* at 306-307.

interstate claims.<sup>199</sup> The former type was considered to be an award within the meaning of Dutch law.<sup>200</sup> The Bill went on to exclude the applicability of the grounds for challenge under the Dutch arbitration law to awards of the Tribunal, and limited them to two grounds of "breach of the principles of proper judicial procedure" and public policy and moral.<sup>201</sup> Iran contended that the Bill would restrict Iran's right to challenge the validity of the Tribunal's awards, and lodged a protest with the Government of the Netherlands.<sup>202</sup>

The restrictive approach of the Bill, considered together with the Rules of the Procedure of the Tribunal, the fact that Iran was the defendant in the majority of the cases, and the enforcement machinery of the Tribunal's awards, explain the importance of the availability of a challenge procedure for Iran in general and under that of Dutch law in particular and further explains the dissatisfaction of Iran with the Bill.

As noted earlier, the procedure of arbitration in the Tribunal is governed by the modified version of the UNCITRAL Arbitration Rules. The Rules lack any provisions for challenging the validity of the arbitration or the award because they were designed to apply to arbitrations which were subject to some national laws which would normally contain rules regarding a challenge.

Furthermore, the mechanism according to which awards rendered against Iran are enforced is such that they would give little chance to challenge those awards in courts other than Dutch courts. Awards rendered against Iran are paid out of a security account with the initial \$1 billion of Iranian funds continuously topped up by Iran to maintain a minimum of \$500 million until all such awards are paid out.<sup>203</sup> There will be no need for the American award-winning parties to enforce the award in any foreign jurisdiction. Therefore, there is no opportunity for the Iranian side to challenge the award in the courts of the country of enforcement as distinct from the courts of the

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<sup>199</sup> *Ibid.*

<sup>200</sup> *Ibid.*

<sup>201</sup> *Ibid.*

<sup>202</sup> Letter from Mohammad K. Eshragh to the Ministry of Foreign Affairs of the Netherlands (24 Feb.1984), reprinted in 5 Iran-US CTR, 405. It reads in part: "it [the Bill] denies Iran the advantages of the applicability of Dutch law which is the automatic subjection of the Tribunal awards to all provisions of the Dutch Arbitration Law, particularly the provisions concerning the challenging of arbitral awards." *ibid* at 410.

<sup>203</sup> Paragraph 7 of the General Principles of the Declaration.

country where the arbitration took place.<sup>204</sup>

In the event, Iran withdrew its challenges and the Bill was never enacted.

The question of the nature of the Tribunal remained unresolved. Professor Amerasinghe objecting to the categorisation of the Tribunal as “a *transnational* tribunal dealing with dispute between states and private parties” contends:

The Iran-US Claims Tribunal is a true international tribunal settling claims which are brought before it as a result of the exercise of the right of diplomatic protection. This is clear from the constitutive documents and has been mentioned by some of the arbitrators on the tribunal. It is similar to, though perhaps not exactly like, the former Claims Commissions (Mexican-U.S., etc.: see the decision in 4 UNRAA). While the two States setting up the tribunal do not appear on behalf of their nationals who bring claims, there can be no doubt that the tribunal is deciding claims which have been referred to it indirectly by the two States in the exercise of the right of diplomatic protection, as happened in the case of the claims commissions. The tribunal, besides, was specifically and directly established by the two *States* which are responsible for the appointment of some arbitrators. Private parties did not participate in setting up the tribunal, as happens in the case of ICC arbitral tribunals, ICSID tribunals and *ad hoc* transnational tribunals, nor do they appoint arbitrators or have any contribution in the determination of the rules of procedure.<sup>205</sup>

Some others have suggested that the Tribunal has a dual function both public and private with an “overwhelming public international aspect.”<sup>206</sup>

On the basis of the public international law aspect of the Tribunal, and having established the lack of effective recourse against awards of the Tribunal under the law of its *situs*, the possibility of challenging awards within the procedural framework of the Tribunal is considered. It was noted that, in the absence of a permanent controlling body in international law, a challenge to the validity of an award of an international tribunal is a matter decided by the rules of procedure agreed upon by the parties.<sup>207</sup>

Under the procedural scheme of the Tribunal, revision of an award is possible for the purpose of interpretation, correction or addition.<sup>208</sup> Under Art.35 the parties are entitled to “request that the arbitral tribunal give an interpretation of the award.” A request for correction may be made by the parties with respect to “any errors in

<sup>204</sup> For example, under the regime of the New York Convention recognition and enforcement can be denied an award on grounds of procedural defects of arbitration. Art.V (1).

<sup>205</sup> Amerasinghe, *supra*, note 195 at 290.

<sup>206</sup> Seifi, *supra*, note 195, at 57; also see Lloyd Jones, *supra*, note 195 at 64-67; Redfern and Hunter, *supra*, note 14, 50.

<sup>207</sup> *Supra*, at 85.

<sup>208</sup> Arts. 35-37 of the Procedural Rules.

computation, any clerical or typographical errors, or any errors of a similar nature.”<sup>209</sup> This type of revision, evidently does not cover mistakes by the Tribunal as to the application of proper law, or factual errors. Art. 37 provides that either party “may request the arbitral tribunal to make an additional award in claims presented in the arbitral proceedings but omitted from the award.” The above Articles are subject to the provisions of Art. 32, paras. 2 to 7 which provides in para. 3: “[T]he arbitral tribunal shall state the reasons upon which the award is based, unless the parties have agreed that no reasons are to be given.”

In comparison with the ICSID remedy of revision<sup>210</sup> which, as noted, provides for revising an award upon the discovery of facts capable of decisively affecting the award, the remedy of revision under the Tribunal’s Rules is of a much narrower scope. It is limited to some administrative errors and does not address the question of the discovery of relevant facts unknown to the Tribunal during the proceedings. This difference in scope is due to the origin of the Tribunal’s Rules (i.e. the UNCITRAL Arbitration Rules) and the kind of arbitration it aims to cover which is generally *ad hoc* commercial arbitration. In such arbitrations there is not much possibility of re-establishing the tribunal after the rendition of the award. Furthermore, arbitrations conducted under the UNCITRAL Rules are in principle subject to the laws of the place of arbitration and the supervision of its courts. To that extent, there may be grounds to challenge the award.<sup>211</sup> The Tribunal, in the absence of any express rule on the possibility of substantive reconsideration or revision of the award, considered the existence of any inherent power to review and revise the award on the ground that the award was based on forged documents or perjury.<sup>212</sup> In practice, the Tribunal has shown little interest in utilising this inherent power to compensate for the lack of a true revision system in its rules of procedure resulting from the adoption of the UNCITRAL Arbitration Rules.<sup>213</sup> The Tribunal has constantly emphasised the finality of its awards and that no forms of review or appeal is allowed under the Procedural

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<sup>209</sup> *Ibid.*, Art.36(1).

<sup>210</sup> Art. 51(1) of the Washington Convention.

<sup>211</sup> See control under national laws, *supra*.

<sup>212</sup> *Dames and Moore v. Iran*, Decision of 17 April 1985, 8 Iran-US CTR, 107, at 113.

<sup>213</sup> *Seifi*, *Supra*, note 195 at 68.

## Rules of the Tribunal.

Similar to regime of the Iran-US Claims Tribunal, the ICSID arbitration acknowledges the importance of the 'finality' of its awards. But, as noted, in the light of other compelling reasons, the ICSID Convention provides for some procedural remedies under certain circumstances.<sup>214</sup> In the study of the control mechanism of the ICSID system and decided cases, it was noted that a lack of jurisdiction, failure by an arbitral tribunal to apply the proper law, failure to decide on all issues presented to it and failure to state reasons were all grounds which, if proven, could render the award a nullity.<sup>215</sup> In the context of the Iran-US arbitration, there may be stronger reasons in favour of having procedural remedies. The large number of claims involved raises the likelihood of rendering defective awards,<sup>216</sup> particularly where, due to the existence of the Security Account, the Tribunal does not have to preoccupy itself with the consideration of the enforceability of its awards.<sup>217</sup>

Arbitration under the Tribunal's regime has been described as delocalised i.e. detached from the law of its situs.<sup>218</sup> The argument for delocalisation, as mentioned earlier, is that the control function in such arbitrations is shifted from the seat of arbitration to the country of its enforcement where the legality of the process and the validity of the award can be examined. This control procedure may not be available with respect to the majority of the Tribunal's awards. As long as there are funds available in the Security Account, there will be no need for the enforcement of awards rendered against Iran in any other country. Thus there will not be any chance for the Iranian party to challenge the validity of the award at the enforcement stage.

The inequality resulting from this enforcement regime is further highlighted by the fact that due to the uncertainty over the application of the New York Convention to 'anational' or 'delocalised' awards, Iran has found it extremely difficult to have the

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<sup>214</sup> *Supra*, 107

<sup>215</sup> *Ibid.*

<sup>216</sup> Seifi, *supra*, note 195 at 59.

<sup>217</sup> The enforceability of the award could have an effect on the decision of the arbitrator e.g. Lagergren in *BP* 53 ILR 297.

<sup>218</sup> See Lake and Tucker, *Judicial Review of the Iran-US Claims Tribunal: Are the Tribunal's Awards Dutch?*, *supra*, note 195; See also *Gould v. Ministry of Defence of the Islamic Republic of Iran*, United States Court of Appeals for the Ninth Circuit 23 October 1989, reprinted in (1990) XV YBCA 605 at 609-10.

Tribunal's awards, rendered in its favour, enforced in the United States.<sup>219</sup> Even if the courts of the country where Iran seeks enforcement of a counterclaim award consider the awards of the Tribunal enforceable, then the American award-losing party can always avail itself of the grounds of refusal of recognition and enforcement under the law of that country and thereby challenge the validity of the award. As noted, due to the existence of the Security Account a similar procedure may not become available to the Iranian side as the US award-winning party does not normally have to enforce the award in other countries. The Tribunal itself has shown little interest to rectify this imbalance by strict adherence to the Algiers Accords and its Rules of Procedure which do not provide for grounds to challenge the validity of the proceedings and the award.

It would appear that the Tribunal Rules follow a one-sided regime of procedural remedies which is more favourable to the US arbitrating parties. A logical explanation for this could be in the fact that the control scheme of the Tribunal was influenced by the surrounding circumstances of its establishment reflected in the establishment of the security account out of the frozen Iranian assets for the payment of awards rendered against Iran.

### 3.4.3 ICC Arbitration<sup>220</sup>

Apart from ICSID which is an international organisation created under the terms of a treaty, other major arbitration institutions administering arbitration of international commercial disputes such as the ICC Court of Arbitration and the Stockholm Chamber of Commerce Arbitration are established within the framework of national laws.<sup>221</sup> Arbitrations administered by such institutions are, in principle, subject to the relevant applicable procedural law, in many cases that of the place of arbitration, and the resultant awards will normally have the nationality of the place of arbitration. Depending on the attitude of a particular national law on arbitration on the one hand,

<sup>219</sup> The problems involved in the enforcement of awards of the Tribunals, most of the awards rendered in favour of Iran remain unsatisfied. See an account of such cases in Lewis, R., *What goes comes back: Can Iran Enforce Awards of the Iran-US Claims Tribunal in the United States*, (1988) 26 *Columbia Journal of Transnational Law* 515.

<sup>220</sup> See in general ICC, *Guide to ICC Arbitration*, Paris:ICC Publishing S.A. 1994; Craig *et al.*, *supra*, note 34; In relation to state contracts see Toope, S., *Mixed International Arbitration: Studies in Arbitration between States and Private Persons*, Cambridge:Grotius 1990, Ch VI.

<sup>221</sup> Art. 24(2) of the ICC Rules indicates the acknowledgment of the Rules of this point.

and the comprehensiveness of the procedural rules of the institution on the other, the supervision imposed on institutional arbitration may vary. In some jurisdictions such supervision over arbitrations conducted by an institution may be minimal in that the arbitration may seem to have been delocalised. This is not however the case since the question of whether there should be any supervision by the national law is decided by the national law itself and therefore the arbitration will have the nationality of the place even if the national law allows for the tribunal's maximum freedom on how to conduct the proceedings.<sup>222</sup>

It may be argued that there is no difference between *ad hoc* and institutional arbitrations with regard to the question of control and procedural remedies since both in that respect are subject to the relevant national law, and therefore there would be no need for the separate consideration of the matter in the context of institutional arbitrations. In principle, this conclusion is correct. However, based on their international aspirations and the global scope of their activities, some arbitration institutions have introduced rules designed to cover every aspect of arbitration in international business disputes. In such arbitrations, national rules of procedure, to the extent permitted, are replaced by the rules of the institution. The policy objectives pursued by an arbitral institution may be different from those of a national law as usually they are to cater for a certain type of consumer and therefore are adapted to their needs. For example, according to the ICC constitution, it is to facilitate the needs of international business, to improve business conditions among nations, and to seek the solution of international economic problems. More specifically, as Toope has rightly noted: "the congruence valued by the creators of the ICC Rules was, of course, congruence between the Rules and the ICC's own policy purpose, which is to encourage increased commercial contract by promoting stability and certainty."<sup>223</sup> It is in this context that the Court of Arbitration of the ICC is "to provide for the settlement by arbitration of business disputes of an international character..."<sup>224</sup> Thus, the question of control function may to some extent rest in the rules of arbitration of the

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<sup>222</sup> *Supra*, 3.3.2.2.

<sup>223</sup> Toope, *supra*, note 71 at 215.

<sup>224</sup> Art. 1(1) of the ICC Rules of Arbitration.

relevant institution which may follow different policies from national laws.

The ICC approach to arbitration is universal.<sup>225</sup> It aims to cover all types of transnational commercial disputes regardless of the nature of the parties' business, the nationality of the parties and whether they belong to the public or private sector.<sup>226</sup> A great number of disputes are annually brought before the ICC Court of Arbitration. It has by far the largest caseload among similar institutions; between 1923 and 1988, a total of 6000 cases were filed.<sup>227</sup> According to the ICC, a large number of these cases related to contracts to which one party was a state or a state entity.<sup>228</sup>

The ICC arbitral awards shall be final and parties shall be deemed to have undertaken to comply with them.<sup>229</sup> In order to ensure the enforceability of the ICC awards and to enhance the degree of independence of arbitration from national laws, the drafters of the rules have given the International Court of Arbitration a supervisory role. The Court of Arbitration is neither a court and nor does it conduct arbitrations. It is an administrative body which "insofar as the parties shall not have provided otherwise appoints or confirms the appointments of arbitrators."<sup>230</sup> This power of supervision extends, among other things, to the "independence" of the arbitrator<sup>231</sup>, the expeditious conduct of proceedings by the arbitrator<sup>232</sup>, and the formal conformity of the award with the enforcement requirements.<sup>233</sup> Art. 21 of the Rules provides the Court with the power of scrutiny of the award:

Before signing an award, whether partial or definitive, the arbitrator shall submit it in draft form to the International Court of Arbitration. The court may lay down modifications as to the form of the award and, without affecting the arbitrator's liberty of decision, may also draw his attention to points of substance. No award shall be signed until it has been approved by the Court as to its form.

The specific purpose of the exercise of this supervision is to ensure the

<sup>225</sup> For a brief history of ICC arbitration see Ch. I, *supra*, 1.3.3.

<sup>226</sup> Craig *et al.*, *supra*, note 34 at 3.

<sup>227</sup> *Ibid.* at 4

<sup>228</sup> *Ibid.* at 10, Toope notes that a majority of these cases relate to normal commercial transactions with state entities where the involvement of the state does not have any bearing on the contract. Toope, *supra*, note 71 at 213-4.

<sup>229</sup> Art. 24.

<sup>230</sup> Art. 2(2) of the ICC Arbitration Rules.

<sup>231</sup> Art. 2 (7).

<sup>232</sup> Art. 2 (11).

<sup>233</sup> Art. 21.

enforceability of the ICC awards.<sup>234</sup> It is to be noted that the Court does not review the facts or questions of law. The focus of the scrutiny is the award itself in its consistency and coherence and also its conformity with the Terms of Reference.<sup>235</sup> Matters covered by Art.21 are merely formalistic, violations of which may not be viewed by courts as fundamental enough to affect the validity of the award. Thus, in *Bank Mellat v. GAA Development Construction Company*, an English court did not agree with the argument that the fact that the dissenting arbitrator had not been given the opportunity to comment on the new draft of an award amounted to misconduct by the two majority arbitrators.<sup>236</sup> The original draft of the award had been returned to the arbitral tribunal by the Court of Arbitration following scrutiny of Art.21 of the Rules of Arbitration.

The ICC Rules do not provide for an appellate review by another body within the institution. The reason is argued to be that arbitrators in the ICC tribunals are experienced lawyers whose decisions are not as much in need of a "second look" as those of the trade association tribunals where laymen may act as arbitrators.<sup>237</sup> Therefore the control machinery of the ICC does not itself provide for a review procedure nor does it provide parties with the right to challenge the validity of the award before the Court of Arbitration. A party dissatisfied with the proceedings and/or with the award may seek remedies before national courts.

According to Art.24(2) "the parties shall be deemed ... to have waived their right to any form of appeal insofar as such waiver can validly be made." Thus the possibility of appeal and other judicial remedies may exist where the national law concerned does not allow a waiver of the right of appeal.<sup>238</sup> The position of various national laws on the question of control of arbitration has already been considered.<sup>239</sup> Some national courts, noting the comprehensiveness of the rules of arbitration of the ICC, and also following their policy of making their country an attractive arbitration *situs*, have adopted a less interventionist policy with regard to ICC arbitrations. In *Mobil v.*

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<sup>234</sup> Art.26.

<sup>235</sup> Craig *et al.* *supra*, note 34 at 347.

<sup>236</sup> [1988] 2 LL.R 44.

<sup>237</sup> Craig *et al.*, *supra*, note 30 at 341.

<sup>238</sup> Craig, Use and Abuse of Appeal, *supra*, note 10 at 179.

<sup>239</sup> *Supra*, 3.3.

*Asamera*<sup>240</sup>, the arbitral tribunal on the question of which version of the ICC Rules, 1955 or 1975, were to apply to an arbitration proceedings commenced in 1974, relating to a dispute arising from a contract entered into in 1968, decided to apply the 1975 version of the Rules which gave the arbitrator greater freedom in procedural matters.<sup>241</sup> Mobil appealed before the New York Court of Appeals. The Court held that parties, by submitting to the ICC arbitration, had agreed to the Rules of the ICC and it was for the arbitrators to determine which Rules of the ICC were intended. As some commentators have observed, the far-reaching effects of this wide interpretation of the parties' agreement could "eliminate the possibility of carrying out the parties' original intent."<sup>242</sup>

In *Bank Mellat v. Helliniki Techniki S.A* the question was whether the respondent in the ICC arbitration held in England could benefit from the English rule so as to ask for security to be deposited by the claimant for the cost of arbitration.<sup>243</sup> The English court refused to issue an order to that effect requested by Bank Mellat, arguing that the ICC Rules were applicable in the case, and that they did not provide for such security.

The position among national laws on the effect of a reference to the ICC Rules as a waiver of Art.24(1) is not uniform. While English courts seem to consider an agreement to arbitrate under the ICC Rules as an implicit incorporation of Art. 24(2)<sup>244</sup>, Swiss and Swedish laws require an express agreement on the waiver of judicial recourse.<sup>245</sup>

As noted, the value of finality is of high importance for private business and institutions promoting business interests. The state parties in arbitration, however, may not appreciate the value of 'finality' as much as their private counterparts. The finality of the process, as noted, could entail the grant of powers to arbitrators that are subject

<sup>240</sup> 487 F.Supp. 63 (S.D.N.Y. 1980).

<sup>241</sup> According to the 1955 version of the rules, in the case of any gaps in the rules of procedure agreed upon by the parties, rules of procedure of the place of arbitration apply. Under the 1975 version of the ICC Rules, in such situations the arbitrators themselves may fill the gaps in the procedure.

<sup>242</sup> Craig *et al.*, *supra*, note 34 at 589.

<sup>243</sup> [1983] 3 All E R 428. See however *S.A. Coppée Lavalin N.V. v. Ken-Ren Chemicals and Fertilizers* [1995] 1 AC 38 (H.L.).

<sup>244</sup> *Arab African Energy Corp. Ltd. v. Olieprodukten Nederland V.V.*, Queen's Bench Division (Commercial Court), Decision of 12 May 1983, [1983] 2 LLR 419.

<sup>245</sup> Craig *et al.*, *supra*, note 34 at 151-152.

to minimal or no control whatsoever. This may not pose many problems for private parties to ICC arbitrations as the system has basically been designed to serve the needs of such clientele. It is doubted, however, that such a system can equally adapt itself to the needs of arbitration of cases which involve the public interest due to having a state as a party.<sup>246</sup> For state parties, fairness and correctness of the process ensuring a degree of sensitivity to the public nature of their contracts may prevail over 'finality'. More specifically, as noted above, the recognition by arbitral tribunal of its sovereign discretions with regard to contract is the primary concern of the state party. In this context, as noted above, the law of the place of arbitration can be relevant with regard to a wide range of the arbitral tribunal's determinations.<sup>247</sup>

More specifically, the applicable substantive law and the method of its determination is often of paramount importance. An stipulation in favour of the ICC arbitration, with no further reference to the place of arbitration and the applicable law, would give the Court of Arbitration the power to choose the place of arbitration. Given the transnational aspirations of the ICC, it would be reasonable to assume that one of the main criteria for the Court in deciding on the place of arbitration, will be the level of recognition by the law of that place of arbitral autonomy; or how far that law enforces party autonomy including the ICC Rules as the choice of procedural rules of arbitration. A choice of such a place would result in the application of the Rules as the exclusive basis of the tribunal's determination of the applicable law. According to these rules, the arbitral tribunal can determine the applicable law according to the conflict rule of its choice.<sup>248</sup> In the light of the the importance of the promotion of contractual stability and certainty in the ICC, resort to the *lex mercatoria* or such general principles as sanctity of contract or good faith in such situations can be a likely option.<sup>249</sup> As will be noted later, such treatment of the determination of the applicable law is not compatible with the interest of the State party to arbitration.<sup>250</sup>

Furthermore, the designers and administrators of the ICC system are primarily

<sup>246</sup> See in general, Toope, *supra*, note 71, Chapter VI.

<sup>247</sup> *Supra*, 3.2.1.

<sup>248</sup> ICC Rules, Art. 13(3).

<sup>249</sup> See in the discussion of the delocalisation of applicable substantive law in Ch.IV, *infra*, 4.3.

<sup>250</sup> *Ibid.*

private lawyers of Western European origin who are more accustomed to the procedural approach of their own legal systems. Rules of arbitration of institutions such as the ICC are mainly based on the Western type court formalism which could create problems with regard to state contract arbitrations.<sup>251</sup>

### 3.5 Conclusions

With regard to the question of control, position of parties to state contracts is influenced by conflicting demands of promotion of stability of contractual relations through reduction and elimination of controlling role of the relevant national public policies and flexibility of contractual relations to meet the changing needs of public interest.

In relation to international commercial arbitration, national laws address the question within the context of private arbitrations; they pay little specific attention to the particular requirements of state contracts with regard to the question of control. However, their public policy control of arbitration may to a varying degree meet public interest requirement of the contract. From the study of the developments of national laws in popular seats of arbitration in the West, it would appear that this public policy control is increasingly compromised in favour of the interests of international trade, in that, the finality of the process and stability of contractual relations are promoted. As a result of such an approach there will be an increased likelihood of rendition of awards on the basis of principles and rules of private law. In principle, such arbitrations are not compatible with the public interest requirement of state contracts. By comparison, arbitrations subject to judicial control are relatively more compatible with the interest of the state since under such control, through determination of the law of the state party as the applicable law or recognition of mandatory rules of the state law, public interest demands of the contract is more likely to be met.

Arbitrations based on multilateral and bilateral treaties are designed to specifically deal with disputes between states and private parties. The study of the ICSID arbitration regime reveals that, the relevant provisions of the Convention are by far more sensitive to the public aspect of investment agreements than national arbitration

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<sup>251</sup>Toope, *supra*, note 71 at 202.

laws. This is reflected in the provisions of the Convention regarding the arbitral tribunal's jurisdictional determination, conduct of the proceedings, the determination of the applicable law and the award.

The regime of arbitrations established following a bilateral treaty, including the question of control, is likely to be influenced by the overall bargaining position of the state parties to the treaty. The control scheme of arbitrations which are agreed upon as part of wider settlement between the two disputing states, such as the Iran-US Claims Tribunal, could be very much influenced by the surrounding circumstances of its establishment and the overall interstate considerations rather than specific legal considerations.

## Chapter IV

### Applicable Substantive Law of State Contracts

#### 4.1 Introduction

The position of the parties to state contracts regarding the question of the applicable substantive law can be summed up as follows: on the one hand, states argue for the applicability of their laws to state contracts together with any relevant treaty obligations which they have consented to. On the other hand, the private parties to state contracts attempt to characterise such contracts as 'a-national' in order to avoid applying the state party's law.

A court of law, in order to determine the law applicable to a contract with an international element, would first search for the parties' choice, express or implied.<sup>1</sup> The degree of recognition of this choice may be influenced by the laws of several jurisdictions including the conflict-of-laws rules or private international law of the forum and the relevant mandatory laws.<sup>2</sup> In the absence of a choice of law by the parties, a court determines the applicable substantive law according to conflict-of-law rules of the forum.<sup>3</sup> A Judge's resort to the conflict-of-laws rules is not a matter of discretion but an obligation imposed on him by the law of his respective state. An arbitrator's position on the question of the determination of the applicable law to the substance may be somewhat different.<sup>4</sup>

Traditionally, arbitral tribunals have dealt with the question of determining the applicable substantive law in the same manner as state courts: reliance on the conflict-of-law rules of the seat.<sup>5</sup> This solution, however, has been criticised on the ground that in many cases the reason for the choice of a particular place as the seat of the arbitral tribunal does not indicate an implied intention of the parties to apply the law of

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<sup>1</sup> For the view of English law see North, P. M. and J. J. Fawcett, *Cheshire and North's Private International Law*, London/Dublin/Edinburgh: Butterworths 1992, ch. 18.

<sup>2</sup> *Ibid.* at 496-503.

<sup>3</sup> For instance, in order to determine the applicable substantive law of a contract, an English court must follow the provisions of the Contract (Applicable Law) Act 1990.

<sup>4</sup> See in general Chukwumerije, O., *Choice of Law in International Commercial Arbitration*, Westport, Connecticut/London: Quorum Books 1994.; Lew, J., *Applicable Law in Commercial Arbitration*, New York: Dobbs Ferry: Oceana 1978; Redfern, A. and M. Hunter, *Law and Practice of International Commercial Arbitration*, London: Sweet and Maxwell 1991, Ch.2.

<sup>5</sup> Redfern and Hunter, *ibid.* at 81; Mann, F. A., State Contracts and International Arbitration. In *Studies in International Law* (Edited book), Oxford: Clarendon 1973, 256 at 262-3.

that state including its conflict-of-laws rules.<sup>6</sup> Other considerations could be involved in deciding a seat such as logistics and convenience or neutrality of the place in relation to the dispute and the parties.<sup>7</sup> These kinds of argument are used as grounds for the introduction of alternative solutions in the context of the determination of the applicable substantive law of contract, some in favour of other conflict-of-laws solutions, and others proposing alternatives leading to the direct application of some substantive legal or non legal standards.<sup>8</sup>

In the context of state contract arbitrations, additional justifications have been mentioned for avoiding the application of conflict-of-laws solutions, especially those based on the conflict rules of the forum.<sup>9</sup> The application of the conflict rules of many legal systems would very often lead to the law of the place with which the contract in question has closest connection being determined to be the applicable substantive law.<sup>10</sup> In the case of state contracts, this normally would be the state party's law since in such contracts the place of conclusion and performance of the contract are both usually situated in the territory of the state party:

“... to the extent that the contract is primarily concerned with transactions which, to a greater or lesser degree, are to be performed in the territorial domain of the State party, the law of the State party normally governs the relationship when the closest link test is applied in the absence of any choice of law provision. Apart from mining concessions including oil concessions, it also happens to be the case with construction and management contracts, turnkey contracts, licensing agreements concerning transfer of technology or some other types of licensing agreements.”<sup>11</sup>

It is for this reason, and the fact that the state, being both contract partner and legislature, might use its legislative power to unilaterally affect its contractual obligations through the change of its law, that various attempts have been made to take such contracts away from the reach of municipal laws, and in particular the national law of the state party to the contract.<sup>12</sup>

<sup>6</sup> Chukwumerije, *supra*, note 4 at 123; also see Ch.III, *supra*, 3.3.1.

<sup>7</sup> Carbonneau, T.E., The Remaking of Arbitration: Design and Destiny, In *Lex Mercatoria and Arbitration*, edited by Carbonneau, New York:Transnational Juris Publication 1990, 1 at 6.

<sup>8</sup> These methods will be dealt with in detail later in this chapter.

<sup>9</sup> See, *infra*, 4.3 and material referred to therein.

<sup>10</sup> Chukwumerije, *supra*, note 4 at 128-30.

<sup>11</sup> Maniruzzaman, A. F. M., Conflict of Law Issues in International Arbitration: Practice and Trends, (1994) 9(4) *Arb.Int.* 371 at 382; also Delaume, G. R., The Myth of the Lex Mercatoria and State Contracts, In *Lex Mercatoria and Arbitration*, *supra*, note 7, 77 at 79.

<sup>12</sup> See in particular the theories of delocalisation of substantive law, *infra*, 4.3.

Proponents of theories in favour of the application of non-national rules to state contracts argue that such contracts form an independent category which provide for far reaching mutual commitments of both a private and a public nature; such contracts are “neither public contracts governed by the municipal law of the state party, nor private commercial contracts, but *sui generis*, of a mixed legal character.”<sup>13</sup> The inclusion in a state contract of clauses providing for the stability of the legal regime of the contract against legislative acts by the state party, and international arbitration as the mode of dispute settlement have been considered as other grounds of delocalisation of such contracts.<sup>14</sup> The differing interests of the parties to such contracts are better protected by subjecting them to principles other than those of municipal law.

The introduction of a new solution to a problem raises questions as to the shortcomings of the old solutions and the way that the situation could be remedied. The main criticism of the application of the state party’s law, as mentioned, has been an imbalance in the contractual regime to the benefit of the state party since it would have the power to unilaterally modify or terminate the contract. Therefore any inquiry should answer the question as to whether the application of the national law of the state party to contracts would create an imbalanced regime, and whether the alternative solutions proposed by the proponents of the delocalisation of state contracts would contribute to the promotion of a more balanced legal regime.

#### 4.2 Conflict of Laws

Any contract which is not international is subject to some municipal laws.<sup>15</sup> This view is based on the assumption of the “central role” of states in national and international law.<sup>16</sup> As mentioned, the conflict-of-laws rules of the seat of an arbitral tribunal are considered the starting point for the determination of the law applicable to

<sup>13</sup> *Amoco Asia v. Republic of Indonesia*, (1985) 24 ILM 1023 at 1030.

<sup>14</sup> *Texaco Overseas Petroleum Company and California Asiatic Oil Company v. The Libyan Arab Republic*, Award of 19 January 1977 (Merits), 53 ILR 389 at 450-457; Kojanec, G., *The Legal Nature of Agreements Concluded by Private Entities with Foreign States*, In *Colloquium 1968- International Trade Agreements*. Leiden: Sijthoff 1968, 299.

<sup>15</sup> *Case concerning the Payment of Various Serbian Loans issued in France*, 12 July 1929, PCIJ Ser. A, No. 20/21; Mann, F. A., *Lex facit arbitrum*, In *International Arbitration: Liber amicorum for Martin Domke*, Edited by P. Sanders, Leiden: Sijthoff 1967, 157 at 159.

<sup>16</sup> See under the Nature of Arbitration, Ch.I, *supra*, 1.3.1; also Ch.VII.

the substance of the dispute.

#### 4.2.1 Party Autonomy

It is a well-accepted principle in different legal systems that the parties to an international contract have the right to choose the law governing it.<sup>17</sup> The development of this principle in various legal systems, Lew observes, has been independent in every country.<sup>18</sup> This principle has been recognised by international conventions such as the Rome Convention on the Law Applicable to Contractual Obligations which provides in Art.3 that “a contract shall be governed by the law chosen by the parties.”<sup>19</sup> The UNCITRAL Model Law and UNCITRAL Rules of Arbitration also have similar provisions.<sup>20</sup> The Washington Convention, as the one dealing specifically with a particular kind of state contract disputes, also recognises the principle of party autonomy. According to Art.42 (1) of the Convention:

“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”

The first sentence of the Article is the express recognition of the party autonomy rule by the Convention. However, it has been argued that the choice of a national law by the parties is subject to the limitation that provisions of that national law should not

<sup>17</sup> In English common law see *R v. International Trustee* [1937]AC 500 at 529; For a general study of the principle and its limitations see Weintraub, R. J., *Functional Developments in Choice of Law for Contracts*, (1984) 187 RCADI 139.

<sup>18</sup>Lew, J., *Applicable Law in Commercial Arbitration*, *supra*, note 4 at 75.

<sup>19</sup>The Rome Convention on the Law Applicable to Contractual Obligation, (1980) No.L 266/1 Official Journal of the European Communities; The Convention has been given effect in the United Kingdom by the Contracts (Applicable Law) Act 1990.

<sup>20</sup> Art. 28 of the Model Law: “The arbitral tribunal shall decide the dispute in accordance with such rules of law as are chosen by the parties as applicable to the substance of the dispute. Any designation of the law or legal system of a given State shall be construed, unless otherwise expressed, as directly referring to the substantive law of that State and not to its conflict of laws rules.”; The UNCITRAL Arbitration Rules, Art.33(1): “The arbitral tribunal shall apply the law designated by the parties as applicable to the substance of the dispute”.

violate the principles of public international law.<sup>21</sup> This interpretation seems to be contrary to the intention of the Article since there is no indication, express or implied, to that effect. Furthermore, if the drafters of the convention had intended to consider any role for international law viz-a-viz a choice by the parties they could have mentioned it in the Article as they did in the case of the second sentence of the same article concerning situations where there is no choice of applicable law.

Therefore in *AGIP v. Congo* a case concerning a nationalisation by the Government party pursuant to an oil distribution agreement which provided for the application of "Congolese law supplemented if necessary by any principles of international law", on all matters, the Tribunal decided according to the Congolese law except mainly matters relating to nationalisation where international law was found generally applicable.<sup>22</sup> The application of international law in this case was based on the choice of law clause of the contract agreed upon by the parties; it should not be interpreted as an automatic application of international law read into the first sentence of Article 42(1) with the effect of limiting the parties' choice of a national law.

The choice of law provisions of the Iran-US Claims Settlement Agreement is less specific on the question. It reads:

The Tribunal shall decide all cases on the basis of respect for law, applying such choice of law rules and principles of commercial and international law as the Tribunal determines to be applicable, taking into account relevant usages of the trade, contract provisions and changed circumstances.<sup>23</sup>

The Tribunal, in deciding its power in determining the applicable substantive law, has broadly interpreted the above provisions, in that, it has often disregarded the party autonomy rule. It has repeatedly declined to apply the national law agreed upon by the

<sup>21</sup> Broches expresses some doubts on the question: "... the question is whether the Tribunal can apply international law where international law is not in terms included in the rules of law agreed by the parties pursuant to the first sentence of Art.42(1). This is a difficult question on which I hesitate to express firm opinion. However, I submit that in this situation the application by the Tribunal of international rules is at least permissible to the extent that these rules are "the law of the land" which is to say that they would presumably be applied by the national courts of the host country." Broches, A., *The Convention on the settlement of Investment Disputes between States and Nationals of other States*, (1972) 136 RCADI 331 at 389.

<sup>22</sup> On the relevance of international law the Tribunal held: "It is in fact in regard to such clauses that the principles of international law supplement the rules of Congolese law. The reference to international law is enough to demonstrate the irregular nature, under this law, of the act of nationalisation which occurred in this case. Consequently, the Government must compensate AGIP for the damage it suffered from the nationalisation..." (1983) VIII YBCA 133 at 140.

<sup>23</sup> Art.5 Claims of the Settlement Agreement.

parties as the governing law of their contract.<sup>24</sup> The Tribunal has justified its disregard for the parties' choice of law on the ground of justice and equity: "our search is for *justice and equity*, even in cases where arguably relevant national laws might be designed to further other and doubtless quite legitimate goals (Italics supplied)."<sup>25</sup> Such strong reliance on justice and equity seems incompatible with the clear provisions of Art.V of the Claims Settlement Agreement and also the fact that the Tribunal can decide *ex aequo et bono* only if the arbitrating parties have expressly and in writing authorised it to do so.<sup>26</sup> The treatment by the Tribunal of the provisions of the Claims Settlement Agreement on the question of the applicable law has been considered as "a justification for achieving a result predetermined to be *fair* or *equitable* by the arbitrators rather than as a set of rules to be followed in reaching a reasoned decision based on law."<sup>27</sup>

The acceptance of party autonomy by arbitral tribunals should not pose any problem considering that court judges, who are by comparison more tied to state laws, recognise the principle. Indeed, the first step of an arbitral tribunal in determining the applicable substantive law is to see whether there is any agreement thereon by the parties. In the context of state contracts, the arbitrator in *LIAMCO* held: "... it is an accepted universal principle of both domestic and international laws that parties to a mixed public and private contract are free to select in their contract the law to govern

<sup>24</sup> In *Gould Marketing*, a claim for breach of contract containing a choice of Californian law clause, the Tribunal considered the contract as having been frustrated and decided the question of allocation of damages resulting from frustration according to the general principles of law. *Gould Marketing, Inc. v. Ministry of Defence of the Islamic Republic of Iran*, (1986) 6 Iran-US C.T.R.272; similarly, in *CMI International, Inc.*, on the question of the applicable law relating to measure of damages for breach of contract, Chamber Two declined to apply the law agreed by the parties, which was the law of Idaho, and instead assessed the damages in accordance with the general principles of law. *CMI International, Inc. v. Ministry of Roads and Transportation and the Islamic Republic of Iran*, 4 Iran-US CTR 263; also in *Oil Field of Texas, Inc. v. Government of the Islamic Republic of Iran, National Iranian Oil Company, Oil Service Company of Iran*, 1 Iran-US CTR 347 at 361, where the arbitral tribunal declined to apply the arbitrating parties' choice of the applicable law.

<sup>25</sup> *CMI International, Inc.*, *ibid* at 268; the Tribunal's reluctance to decide cases according to national laws, differences in legal cultures of the parties and arbitrators have been mentioned as a reason. *Toope, Mixed International Arbitration: Studies in Arbitration between States and Private Parties*, Cambridge: Grotius 1990, at 310. This however does not seem justified since one reason for submitting to any arbitration is usually that the parties, being aware of the fact that they belong to different legal backgrounds, try to avoid foreign courts by agreeing on arbitration; therefore, the above differences are present in many arbitrations and thus should not be considered as a separate ground for disregarding the choice of national laws.

<sup>26</sup> Art. 33 of the Tribunal Rules.

<sup>27</sup> Westberg, J., *The Applicable Law Issue in International Business Transactions with Government Parties-Rulings of the Iran-US Claims Tribunal*, (1988) 2 ICSID Review 473 at 481.

their contractual relationship.<sup>28</sup>

The parties' choice may be express or implied. Lew maintains that, in principle, almost all those systems which accept an express choice-of-law also accept an implied choice.<sup>29</sup> In the latter case, the arbitral tribunal will have to infer the intention of the parties. A problem here is *how* to discover the intention of the parties which have not expressed any agreement on the governing law of their contract. Various factors have been taken into account, individually or collectively, including the language of the proceedings, the nationality of the arbitrators, and, more importantly, the seat of the arbitration.<sup>30</sup> The latter for long played a conclusive role in implying the intention of the parties. A choice of a forum was considered to be the choice of its laws to be applied to the substance of the dispute; *qui elegit arbitrum elegit ius*. However, modern arbitration practice does not always recognise the above presumption as the sole indicator of the applicable law.<sup>31</sup> Thus today the presumption is often used in combination with other factors.<sup>32</sup>

The implied autonomy rule is not as widely recognised by arbitral tribunals as express party autonomy.<sup>33</sup> It is rather difficult to imagine that in the absence of an express choice, the arbitral tribunal can discover the actual intention of the parties especially when the heavy burden of proof of the existence of such a choice is on the party claiming its existence. In a number of cases relating to state contract disputes, however, the absence of a choice by the parties has been interpreted as an implied choice to the exclusion of the law of the state party and of the application of a delocalised substantive law.<sup>34</sup> Such a view was taken by the arbitrator in the *Sapphire* where in the interpretation of a contract clause providing for an obligation of the parties

<sup>28</sup> *Libyan American Oil Company (LIAMCO) v. the Government of the Libyan Arab Republic*, 62 ILR 140 at 172-3.

<sup>29</sup> Lew, *Applicable Law*, *supra*, note 4 at 182.

<sup>30</sup> Collins, L., *Dicey and Morris: The Conflict of Laws*, 12 Ed. 1993, 577-8.

<sup>31</sup> See per Lord Wilberforce in *Compagnie d'Armement Maritime S.A. v. Compagnie Tunisienne de Navigation S.A.* [1971] A.C. 572 at 573.

<sup>32</sup> Redfern and Hunter, *supra*, note 4 at 77-9; also Dicey and Morris, *supra*, note 30 at 577.

<sup>33</sup> Lew, *supra*, note 4 at 209.

<sup>34</sup> This view was first expressed by McNair that the absence of a choice by the parties of a particular system of law should be considered as a reflection of their intention that their contract should be governed by the general principles of law. McNair, A. D., *The General Principles of Law Recognized by Civilised Nations*, (1957) 33 BYIL 1 at 10.

to carry out the provisions of the contract according to principles of "good faith" and "good will" it was held that the agreement was governed by the principles of law recognised by civilised nations: "It [was] therefore perfectly legitimate to find in such a clause evidence of the intention of the parties not to apply the strict rules of a particular system but, rather, to rely upon the rules of law, based upon reason, which are common to civilised nations."<sup>35</sup> Therefore, the arbitrator considered a lack of reference to any positive law as a deliberate omission designed to exclude the application of Iranian law.<sup>36</sup> In *Texaco*, the arbitrator considered, among other things, the choice of arbitration as a dispute settlement method<sup>37</sup> and the inclusion of a stabilisation clause as evidence of the parties' intention to internationalise the contract.<sup>38</sup>

#### 4.2.1.1 Scope of Party Autonomy

In principle, the private international law rules of various legal systems impose certain limitations on the parties' freedom to choose the governing law of their contract. For instance, in English common law, a choice of law by the parties should be *bona fide*, legal and not contrary to the public policy (of the forum).<sup>39</sup> The choice of a particular law to avoid the mandatory rules of the country with which the contract has closest connection may not be considered *bona fide*. Mandatory rules of law are those imperative provisions of law "which must be applied to an international relationship irrespective of the law that governs that relationship".<sup>40</sup> In other words, such rules have been defined as rules "which cannot be derogated from by contract".<sup>41</sup> In

<sup>35</sup> *Sapphire International Petroleum Ltd. v. The National Iranian Oil Company*, (1963) 35 ILR 136 at 173.

<sup>36</sup> Delaume criticises the view taken by the arbitrator in this case arguing that "unless express reference is made to international law or to the general principles of law, a reference to good faith is merely a reminder of an elementary rule of contract law. This view should apply even when the contracting state is a developing nation. Delaume, *The Myth of the Lex Mercatoria and State Contracts*, *supra*, note 11 at 82.

<sup>37</sup> *Texaco Overseas Petroleum Co. v. Libyan Arab Republic*, 53 ILR 389 at 454-55.

<sup>38</sup> *Ibid.* at 456.

<sup>39</sup> *Vita Food Products Inc. v. Unus Shipping Co. Ltd.* [1939] AC 277 at 290; Art. 2 of the U.S. Uniform Commercial Code (UCC), adopted by the majority of the states, provides for the party autonomy rule in sale of goods agreements and reads: "... When a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties..." Thus it requires a territorial link between the parties choice and the transaction.

<sup>40</sup> Mayer, P., *Mandatory rules of law in international arbitration*, (1986) 2 Arb. Int. 274 at 275.

<sup>41</sup> Art.3(3) of the Rome Convention.

principle, mandatory rules of various municipal laws may be relevant including those of the forum jurisdiction, those of the *lex contractus* and those of the laws which have close contacts with the contract.<sup>42</sup> This position has been reflected in the relevant provisions of the Rome Convention:

“When applying under this convention the law of a country, effect may be given to the mandatory rules of the law of another country with which the situation has a close connection, if and so far as under the law of the latter country, those rules must be applied whatever the law applicable to the contract. In considering whether to give effect to these mandatory rules, regard shall be had to their nature and purpose and to the consequences of their application or non-application.”<sup>43</sup>

In the context of state contracts, it is claimed that since the contract has close connections with the country of the state party the choice of applicable law may be overridden by the “statutes of such states having a substantial contact with the contract”.<sup>44</sup> It has been argued that the position of the arbitrator concerning mandatory rules may be different from that of a judge; the applicability of mandatory rules is subject to the approval of ‘truly international public policy’. This view has been described as follows:

If an excluded law by the parties was considered to be contrary to truly international public policy by virtue of its content, an arbitrator would have to give effect to the intention of the parties. If the object of that law was considered to guarantee the respect of principles considered by the arbitrator as forming part of truly international public policy, the arbitrator would have to make that law, or at least its principles, prevail over the will of the parties.<sup>45</sup>

Mayer is of the opinion that a state, by entering an arbitration agreement, undertakes not to take legislative measures against the other contracting partner and therefore such measures should not override the provisions of the law chosen by the parties.<sup>46</sup> However, he maintains that if their applications have not been expressly excluded, “measures of general scope adopted in the public interest” should be recognised “so long as they do not have the result of conferring on the state an advantage at the

<sup>42</sup> See, Chukwumerije, *supra*, note 4, Chapter Six; Lazareff, S., Mandatory Extraterritorial Application of National Law, (1995) 11(2) Arb.Int. 137.

<sup>43</sup> Art.7(1).

<sup>44</sup> Sornarajah, *International Commercial Arbitration*, Singapore: Longman 1990, at 107; In *Aminoil*, the Tribunal considered the effects of certain public laws of the host country on Aminoil and held that those laws were enforceable despite their unilateral nature. In relation to the embargo imposed during the 1973 War which affected the Aminoil’s shipments of oil to a number of countries, the Tribunal held that although not provided for under the various contracts of concession, the embargo was validly imposed upon the concessionaire.” *Aminoil Award*, (1982) 21 ILM 976 at 1008.

<sup>45</sup> Hochstrasser, D., Choice of Law and “Foreign” Mandatory Rules in International Arbitration, (1994) 11 J.Int.Arb. 54 at 69.

<sup>46</sup> Mayer, *supra*, note 40 at 292.

expense of its cocontractant”<sup>47</sup> In principle, the view that the arbitrator’s position with regard to the application of the relevant mandatory rules of foreign laws is different from that of a judge seems questionable as the choice of forum, *forum selectum*, should not affect the choice of law rules. If the application of mandatory rules cannot be excluded by the agreement of the parties, *a fortiori* it cannot be excluded by the arbitrator as the arbitrator, like the parties, is bound by the public policy requirements of the relevant laws. In relation to the applicability of mandatory rules, unless the public policy requirements of the relevant laws is explicitly relaxed in favour of party arbitral autonomy, an arbitrator’s position is the same as a judge. The arbitrator does not enjoy any discretion as to this matter. This conclusion has been endorsed even by some writers otherwise in favour of arbitral autonomy.<sup>48</sup> In particular, the arbitrator should “guarantee the respect for the mandatory rules of the place of performance of the contract, which arbitrators consider to apply as a matter of course when they have to decide on the applicable law where the parties have not chosen the *lex contractus*.”<sup>49</sup>

The inequality of the parties may be considered as another limitation to the ‘party autonomy’ rule. This is recognised by the Rome Convention in relation to consumer and employment contracts; the parties’ choice of law may not have the effect of depriving the consumer or employee of the protection of certain mandatory rules.<sup>50</sup> It has been argued that “where a developing country or its instrumentality, which does not have sophisticated legal facilities contracts with a foreign multinational, there is room to draw a presumption of inequality” and accordingly challenge the choice of law provisions.<sup>51</sup> The argument is based on an analogy drawn between adhesion contracts of domestic law and international commercial contracts; in both one party might be of a

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<sup>47</sup> *Ibid.*

<sup>48</sup> Lazareff, *supra*, note 42.

<sup>49</sup> Hochstrasser, *supra*, note 45 at 69.

<sup>50</sup> Arts. 5(2) and 6(1) of the Convention. For a commentary of the Articles see Lasok, D. and P. Stone, *Conflict of laws in the European Community*, Professional Books Limited 1987 at 380-85.

<sup>51</sup> Audit, B., *Transnational Arbitration and State Contracts: Finding and prospects*, Kluwer 1988 at 110-112; Sornarajah, *supra*, note 37 at 108 and 110-12; also see in *Klöckner* case where the Tribunal held that the investor owed a “duty of disclosure” to its partner. The award and commentary in Paulsson, J., *The ICSID Klöckner v. Cameroon Award: The Duties of Partners in North-South Economic Development Agreements*, (1984) 1 *Journal of International Arbitration* 145.

weaker bargaining power and in the need of the protection of the law in the form of not giving effect to the choice of the parties.<sup>52</sup>

There are national laws which impose restrictions on the state or its entities with respect to the law applicable to their international contracts, in that, the state or the state entity party to a state contract can only agree to a choice of its national law.<sup>53</sup>

#### 4.2.2 Determination of the Applicable Law by the Arbitrator

It was noted above that, in the absence of an express choice, an arbitral tribunal would try to find the unexpressed intention of the parties as to the law governing their legal relationship. Here, the issue in cases where there has been no choice by the parties, neither implied nor express, is considered. In this context, the initial question is whether the arbitrator should determine the applicable law according to some conflict-of-laws rules, and if so, whether he should apply the conflict rules of the seat of the arbitration or other conflict rules.

For a court the question would not pose much difficulty as it would be guided by the conflict rules of the forum which would determine the proper law of the contract. There is a rebuttable presumption in many conflict-of-laws rules in favour of the application of the *lex fori* as the proper law of contract<sup>54</sup> Arbitral tribunals, as noted, for a long time applied the conflict rules of the forum in their search for the applicable substantive law. In the case of state contracts, the application of conflict of law rules almost invariably results in the designation of the state party's law as the governing law of the contract.<sup>55</sup> Although, there still exists a great deal of support for this method, it has faced challenges in different forms by the proponents of the

<sup>52</sup> Weintraub, *supra*, note 17 at 273-4; Also, Sornarajah, *ibid.* He mentions several US cases where the Supreme Court while expressing its liberal attitude to international contracts in the context of validity of forum selection clauses, emphasised that the clause would be set aside if the contract was tainted by "undue influence or overweening bargaining power". By way of analogy, he considers the *dicta* also applicable to choice of law clauses. See also the cited cases in the accompanying text.

<sup>53</sup> E.g. Saudi Arabia. See Van den Berg, National Report on Arbitration: Saudi Arabia, in *Handbook Commercial Arbitration.*, Edited by P. Sanders, Deventer: Kluwer.

<sup>54</sup> *Companie d'Armement Maritime S.A. v. Companie Tunisienne de Navigation S.A.*, [1970] 3 All E.R. 71, 3 WLR 389 (H.L.); *Scherk v. Alberto-Culver Co.*, 417 US 506, 519 n.13 (1974).

<sup>55</sup> Manniruzzaman, *supra*, note 11 at 383.

delocalisation of arbitration.<sup>56</sup> The most extreme of such challenges aims to achieve the absolute detachment of arbitration from any system of law.<sup>57</sup> It starts by disconnecting the link between the conflict-of-laws rules applied by the arbitral tribunal and the procedural law of the arbitration.<sup>58</sup> Thus, a choice of a procedural law would not automatically lead to the application of its conflict rules.

Different views on the question of the power of the arbitrator to determine the applicable law are largely influenced by different perceptions of the underlying nature of arbitration. The jurisdictionalist theory of arbitration, as noted earlier in this work, considers that an arbitral tribunal derives its power from a system of law - *lex arbitri* - which is a national legal system in the case of a private arbitration.<sup>59</sup> The *lex arbitri* including its conflict-of-laws rules sets the limits of the power of arbitral tribunals in deciding the question of the applicable law. The parties' choice of the applicable law is valid as long as that national law upholds it. In the absence of a choice by the parties, it will be for the conflict rules of *lex arbitri* which in many cases is the same as *lex loci arbitri*, to determine the applicable law.<sup>60</sup>

According to the contractualist theory of arbitration, on the other hand, the parties can choose the law applicable to their contract and arbitration free from any constraints of national laws. The arbitrator receives his power from the agreement of the parties. If the parties are free to choose any standard, be it a municipal system of law or some non-municipal standards, the arbitrator similarly should be able to do so and he should not be bound by any national law (including their conflict rules). The arbitrator in

<sup>56</sup> Goldman, B., The applicable law: general principles of law- the *lex mercatoria*, In *The Contemporary Problems in International Commercial Arbitration*, edited by J. Lew, London: Kluwer 1986 ; Lando, O., The *lex mercatoria* in international commercial arbitration , (1985) 34 ICLQ 747-768; Paulsson, J., Arbitration unbound: award detached from the law of its country of origin , (1981) 30 ICLQ 358-387; Paulsson, J., Delocalisation of international commercial arbitration: When and why it matters , (1983) 32 ICLQ 53.

<sup>57</sup> See chapter III, *supra*, 3.3.2.2.

<sup>58</sup> Toope, *supra*, note 25 at 46.

<sup>59</sup> Mann, for instance, maintains:

Although , where international aspects of some kind arise, it is not uncommon and, on the whole, harmless to speak, somewhat colloquially of the international arbitration, the phrase is a misnomer. In the legal sense no international commercial arbitration exists... Every arbitration is a national arbitration, that is to say, subject to a specific system of national law... Every right or power a private person enjoys is inexorably conferred or derived from a system of municipal law. Mann, *supra*, note 15 at 159-160.

<sup>60</sup> See *James Miller v. Whiteworth Street Estates*, (1970)1 All E.R. 796 (H.L.) where the doctrine that the procedure of arbitration is governed by the law of its seat.

*Sapphire* made the distinction between the arbitration and the court proceedings and held that arbitral tribunals are not bound by the conflict rules of the forum as they do not derive their authority from the state law but from the agreement of the parties.<sup>61</sup>

### *National Laws*

There is no uniform approach among national laws concerning the question of the determination of the applicable law by the arbitrator. Many national laws support the view that the question is one of conflict of laws. According to this view, the arbitrator, in the absence of a choice of law by the parties should make his decision on the substance of the dispute according to the law determined by the rules of conflict, very often those of the place of arbitration. Such rules may directly point to a substantive law or to the conflict-of-laws rules of another legal system. English law requires the arbitrator to rely on English general choice of law rules for the determination of the proper law.<sup>62</sup> Therefore, in the absence of an express choice of law clause in the contract, the "intention of the parties is inferred from the terms and nature of the contract, and from the *general circumstances of the case* and such inferred intention determines the proper law of the contract."<sup>63</sup> The position is largely the same under German law where the arbitrator in international arbitrations held in the German territory, failing a choice of substantive law by the parties, is bound to apply the conflict-of-laws rules of German law to determine the applicable law.<sup>64</sup> The application of a foreign law so chosen may not violate German public policy.<sup>65</sup> An arbitrator deciding a case in Denmark is to determine the applicable substantive law according to such private international law rules (conflict-of-laws rules) that have a close and significant connection with the case.<sup>66</sup>

Arbitrators deciding an international arbitration in Canada and in Scotland have

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<sup>61</sup> 35 ILR at 173.

<sup>62</sup> See in general Collins, *supra*, note 30, Ch. 32.

<sup>63</sup> Steyn, J., National Report on Arbitration: England, In *Handbook Commercial Arbitration* (loose leaf), *supra*, note 43 at 22-23.

<sup>64</sup> Glossner, O., National Report on Arbitration: FR.Germany, *ibid.* at 15.

<sup>65</sup> *Ibid.* The position is the same under the laws of India and Argentina. See Krishnamurthi, N. National Report on Arbitration: India, *ibid.* at 14. Grigera Naon, H. A., National Report on Arbitration: Argentina, *ibid.* at 18.

<sup>66</sup> Philip, A., National Report on Arbitration, Denmark, *ibid.* at 19.

greater freedom in deciding the question of applicable law, as these countries, having incorporated the UNCITRAL Model Law, allow the arbitrator to determine the governing law according to the conflict-of-laws rules that he considers applicable.<sup>67</sup> The member countries of the Inter-American Commercial Arbitration Convention take the same view.<sup>68</sup> Some national laws provide for a higher degree of freedom for arbitral tribunals on the question of the determination of the applicable law by allowing them to make their decisions without resorting to any conflict rules. For instance, according to the Netherlands Arbitration Act of 1986, in the absence of a choice of law by the parties, "the arbitral tribunal shall make its award in accordance with the rules of law which it considers appropriate".<sup>69</sup>

It is to be noted that in all the laws mentioned above the arbitrator has to decide the case on the basis of the *law* which is determined pursuant to the application of some conflict rules or chosen by the arbitrator, in that, the arbitrator is bound to base his award on some law. French law however has gone even further by allowing the arbitrator to decide a case, in the absence of a choice of law by the parties, on the basis of whatever rules he deems appropriate.<sup>70</sup> Therefore he does not necessarily have to decide the case according to any rule of law. In the context of the determination of the applicable substantive law by an arbitral tribunal, French law has taken the most liberal approach by granting arbitral tribunals the highest degree of freedom.

### *International Conventions and Rules of Arbitration*

International conventions and rules of arbitral institutions contain provisions guiding arbitral tribunals in their search for the law applicable to the substance of a dispute.

<sup>67</sup> See in general Paterson, R. K. and B. J. Thompson. *The UNCITRAL Model Law in Canada*. Toronto/Calgary/Vancouver: Carswil 1987.

<sup>68</sup> Art. 33(1): The arbitral tribunal shall apply the law designated by the parties as applicable to the substance of the dispute. Failing such designation by the parties, the arbitral tribunal shall apply the law determined by the conflict of laws rules which it considers applicable. Norberg, C.R., General Introduction to Inter-American Commercial Arbitration., In *Handbook Commercial Arbitration*, *supra*, note 53, Annex II at 12.

<sup>69</sup> Art.1054(2) of the Netherlands Arbitration Act 1986, reprinted in Redfern and Hunter, *supra*, note 4 at 774.

<sup>70</sup> Art. 1496 of the French Code of Civil Procedure states:

The arbitrator shall decide the dispute according to the rules of law chosen by the parties; in the absence of such a choice, he shall decide according to the rules he deems appropriate.  
In all cases he shall take into account trade usages.

According to the Rome Convention on the Law Applicable to Contractual Obligations of 1980, failing a choice of law by the parties, "the law of the country with which [the contract] is most closely connected" is the applicable law of the contract.<sup>71</sup>

In the CMEA countries, in matters covered by the General Conditions of Delivery of Goods, the conflict rules of the country of the sellers will be the basis on which the arbitrator determines the applicable law.<sup>72</sup> With contracts not covered by the General Conditions and similar legal instruments, the arbitrators usually apply the conflict rules of the place of arbitration.<sup>73</sup>

International conventions and rules dealing specifically with international commercial arbitration have given more power to arbitral tribunals to determine the applicable substantive law. The first international convention on arbitration to deal with the question without reference to national laws was the European Convention of 1961 which provides in Art.VII that:

"the parties shall be free to determine, by agreement, the law to be applied by arbitrators to the substance of the dispute. Failing any indication by the parties as to the applicable law, the arbitrators shall apply the proper law under *the rule of conflict that the arbitrators deem applicable*. In both cases the arbitrators shall take account of the terms of the contract and trade usages (italics supplied)."

Thus, the arbitral tribunal has discretion to decide which rules of conflict to apply which may not necessarily be those of the seat. Similar provisions are found in the UNCITRAL Arbitration Rules and also in the Model Law and in the Inter-American Arbitration Rules.<sup>74</sup>

The rules of private arbitration institutions have adopted a similar approach. Art.13(3) of the 1988 ICC Rules of Conciliation and Arbitration allows the arbitrators to apply such rules of conflict as they deem appropriate. The 1991 International Arbitration Rules of the American Arbitration Association (AAA) allows the arbitral

<sup>71</sup> Art.4 of the Convention. The Rome Convention on the Law Applicable to Contractual Obligations, (1980) No.L 266/1 Official Journal of the European Communities. For an analytical study of the choice of law provisions of the Convention see Weintraub, *supra*, note 17 at 278-289.

<sup>72</sup> Strohbach, H., National Report on CMEA Countries, In *Handbook Commercial Arbitration*, *supra*, note 53 at 14.

<sup>73</sup> *Ibid.*

<sup>74</sup> UNCITRAL Arbitration Rules, Art.33: "... Failing such designation by the parties, the tribunal shall apply the law determined by the *conflict of laws rules* which it considers applicable"; The UNCITRAL Model Law on International Commercial Arbitration, Art.28(2): "Failing any designation by the parties, the arbitral tribunal shall apply the law determined by the conflict of laws rules which it considers applicable"; identical provisions are contained in Art.33(1) of the Rules of Procedure of the Inter-American commercial Arbitration Convention.

tribunal to directly determine the law or laws that it deems appropriate without having to resort to the conflict-of-laws rules.<sup>75</sup>

From the above study of new legislation, international conventions and rules on international commercial arbitration, a trend would appear in favour of the expansion of the power of arbitral tribunals in the determination of the applicable substantive law in the absence of a choice by the parties. In a number of jurisdictions, which are often chosen as the seat of arbitration, arbitral tribunals are free to choose the applicable conflict-of-law rules or decide directly on the applicable legal standard. An arbitral tribunal might choose the conflict-of-laws rules of the national legal system which has the closest connections with the case.<sup>76</sup> Alternatively, it might resort to cumulative application of the relevant conflict rules<sup>77</sup>, comparative methods of conflict of laws<sup>78</sup>, or try to find conflict-of-law rules in international law or some non-national sets of conflicts rules set by international conventions.<sup>79</sup> Arbitrators often mention that the application of different relevant conflict-of-laws rules would produce the same result.<sup>80</sup> In the case of state contracts, the application of conflict of law methodology is most

<sup>75</sup> Art.29(1) of the 1991 AAA International Arbitration Rules.

<sup>76</sup> *ICC Case No.6281* of 26 August 1989 reprinted in (1990)15 YBCA 96 at 97-98

<sup>77</sup> The problem with this approach is, it has been argued, that it cannot be used when the application of the relevant conflict rules point to different laws as the substantive law. Chukwumerije, *supra*, note 4 at 128-9 and the cases cited therein.

<sup>78</sup> According to this view, there are certain principles of private international law which are shared by all or majority of the legal systems. These principles are often contained in the international conventions. On this point an ICC tribunal did not find it necessary to decide on a particular "[r]ule of conflict to designate the proper law of the contract in view of the fact that most major rules in some form or other point to the place of the characteristic or dominant work. *ICC Case no. 4650, (1987) XII YBCA 111.*

<sup>79</sup> Public international law has been mentioned to contain conflict rules according to which the substantive law of the arbitration of a state contract may be decided. See in *Texaco Award*, 53 ILR 389 at 445 ; Extracting conflict-of-laws rules from public international law seems rather unconvincing. There is no coherent and clear set of rules in international law dealing with questions of conflict concerning contractual obligations. Reference to such rules as the basis of the determination of the applicable law could be used just as a guise for the direct application of some legal or non-legal standards by the arbitrators. The Tribunal in *Aramco* noted: "It is a principle universally admitted in private international law that the law governing relations which were not established between states, is to be determined by resorting to the conflict rules of the *lex fori*. But, for an arbitration tribunal which is directly subject to international law as a result of the jurisdictional immunity of states, there is no *lex fori* to indicate what conflict rules should be used, since general public international law does not contain any such rules. *Aramco award*, 27 ILR 117 at 156. Furthermore, as Toope maintains, "[I]n practice, the resort to a supposed body of "international" conflict rules would almost always result in the application of highly abstract rules such as "good faith". Such an approach is particularly inappropriate when the parties have attempted to construct a complex choice-of-law clause incorporating different systems law. Such clauses require interpretation simply because they are so complex, but to resort to "international" conflicts rules would undermine the clauses." Toope, *supra*, note 25 at 56.

<sup>80</sup> See the *ICC Case No.6281*, reprinted in (1990) XV YBCA 96.

probably results in the designation of the law of the state party as the governing law.<sup>81</sup>

The ICSID Convention, as a convention dealing exclusively with a category of state contracts i.e. investment disputes, follows a different and more restrictive approach. According to the Convention, failing a choice by the parties, "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".<sup>82</sup> The Convention appears to limit the power of the arbitrator in choosing the applicable law to the direct application of the state law in conjunction with international law.<sup>83</sup> The Convention's answer is one of conflict of laws. The allowance for the application of the conflict-of-laws rules of the state party is an endorsement of the applicability of conflict of law rules of the state which has the closest connection with the case. Furthermore, the application of the substantive law of the state points to the recognition by the Convention of the closest connection rule common to many national laws.

In a number of arbitral awards relating to state contract disputes, arbitrators faced with certain contractual provisions, decided to opt for a non-national choice which has resulted in the so-called delocalisation of state contracts. In line with such decisions, a number of theories have been put forward which will be the focus of the next section of this chapter.

### 4.3 Delocalisation of State Contracts

It is the common object of all methods of delocalisation, in order to introduce a level of stability into the contract regime, to take the contract away from the reach of the law of the state party. To this end various doctrines have been advanced largely by the academics of industrial market-economy countries and to a lesser extent by some arbitral tribunals, occasionally having the same academics on their panel of arbitrators. The delocalisation of substantive law is mainly achieved by removing state contracts, wholly or partially, from a national legal order and placing them within the

<sup>81</sup> Maniruzzaman, *supra*, note 11 at 384.

<sup>82</sup> Washington Convention of 1965, Art.42(1).

<sup>83</sup> For the interpretation of the Article in the light of its drafting history and decided cases see ICSID and Applicable Substantive law, *infra*, 160-64.

international or a third legal order. Although, in many respects these methods may seem similar, due to their different theoretical bases and also the fact that they have been advanced under different titles, they are considered separately.

#### 4.3.1 *Grundlegung*

In the *Texaco award*, the sole arbitrator Dupuy drew a distinction between the “law which governs the contract and the legal order from which the binding nature of the contract stems.”<sup>84</sup> The latter has been referred to as “*ordre juridique de base*” in French law or “*grundlegung*” in German law. By removing the question of the binding nature of the contract from the governing law, a change of the latter would not affect the original obligations contained in the contract; in other words, in state contracts governed by the law of the state party, the state may not evade its contractual obligations by changes made to that law. This is because the contract derives its binding force from another source which according to Dupuy is international law.<sup>85</sup> In effect the doctrine narrows the scope of the application of the proper law determined according to conflict-of-laws rules.<sup>86</sup>

The aim of the *grundlegung* doctrine, elaborated by Professor Weil, is to promote some degree of contractual security in relation to state contracts particularly so called ‘economic development agreements’. It determines the law applicable to the interpretation and performance of the contract as well as validating it.<sup>87</sup> The distinction between the law governing the validity of the contract and that governing the interpretation and performance was further elaborated in *Texaco*.<sup>88</sup> The sole arbitrator Dupuy drew an analogy between the validity of an arbitration clause in an international contract and the validity of the contract itself.<sup>89</sup> The validity of an arbitration clause

<sup>84</sup> *Texaco Award*, 53 ILR 389 at 443.

<sup>85</sup> *Ibid.*

<sup>86</sup> Riad, F. and El-Kosheiri, The law governing a new generation of petroleum agreements: Changes in the arbitration process, (1986) 11CSID Rev.-FILJ. 255 at 272.

<sup>87</sup> Alvarez, H. The distinction between the law governing the binding nature of a state contract and the law governing its application and interpretation (unpublished paper), (1987) Centre for Research and Studies in International Law and International Relations, The Hague Academy of International Law, 14 quoting Weil, P., *Droit international et contrats d'Etat*, In *Melanges Reuter*, Paris: Pedone 1981 at 580; Also, Seidl-Hohenveldern, The theory of quasi-international agreements, (1975) 11 RBDI. 567 at 569.

<sup>88</sup> *Texaco Award*, 53 ILR 389 at 446.

<sup>89</sup> *Ibid.*

does not stem from the contract since it survives even when the contract is not valid according to its proper law.<sup>90</sup> In other words, the validity of the arbitration clause does not depend on the recognition of the proper law. By analogy, the validity of an international contract is not governed by its proper law.<sup>91</sup> It is further argued that it is not the agreement of the parties, expressed or implied, which is the basis of the validity of the arbitration clause regardless of the proper law of the underlying contract, but it is the fact that the arbitration clause is part of an international contract.<sup>92</sup> Further, the methods of internationalisation of contracts are considered by the arbitrator, in that, he makes reference to contracts which "would come under a specific legal order created by the contract itself" which are subject to "a set of rules constituted by the *lex mercatoria*".<sup>93</sup> He argues that another way of internationalisation is to have international law as the applicable law of the contract which would make a contract an international one and therefore it would derive its binding force from international law.<sup>94</sup> The distinction between the *grundlegung* and the proper law of state contracts was also mentioned in *Rever Copper*.<sup>95</sup>

On the question of the identification of international law contracts, it has been maintained that there should be a distinction between two types of state contracts in the light of the circumstances surrounding the contract.<sup>96</sup> For those which are deeply rooted in the international politico-economic system the legal order is international law.<sup>97</sup> Not every state contract will have to be considered as originating from the international judicial order but only those objectively linked to an order covering the relations of states i.e. essentially -but not exclusively-economic development agreements or investment contracts.<sup>98</sup> Therefore, there could be state contracts which have a domestic law as their *grundlegung* and others which are rooted in the

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<sup>90</sup> *Ibid.*

<sup>91</sup> *Ibid.*

<sup>92</sup> *Ibid.*

<sup>93</sup> *Ibid.* at 447.

<sup>94</sup> *Ibid.* at 450.

<sup>95</sup> *Rever Copper and Brass Inc. v. Overseas Private Investment Corporation* 56 I.L.R. 258 at 272-9.

<sup>96</sup> Alvarez, *supra*, note 87 at 13-15.

<sup>97</sup> *Ibid.*

<sup>98</sup> *Ibid.*

international legal order. Furthermore, theoretically a contract could be rooted in the international legal order despite being governed by a municipal law as its proper law.<sup>99</sup>

There are objections to the theory on different grounds. One comes from a private international law approach which believes that the binding force and interpretation and performance of a contract all are governed by the same law which is determined by the conflict-of-laws rules: "Any 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".<sup>100</sup> The distinction between the *grundlegung* and the proper law of a state contract, it is argued, offends the accepted principles of private international law:

In private international law it is not usual to distinguish between the law governing a contract and the law in which it is anchored or from which it derives its binding force. Both functions are filled by the law applicable to the contract or the proper law. Although the substantive rules of that law are applicable because of their designation by the conflict of laws rules of the *lex fori*, it is the rules of the proper law which govern the validity of the contract and give it its binding force. The conflict-of-laws rule of the *lex fori* does not belong to the legal order from which the contract draws its binding force; rather, it seeks to designate the application of a legal system with a closer, preexisting connection to the contract. Therefore, it cannot be the source of the binding force of the contract.<sup>101</sup>

Mayer questions the usefulness of the theory as he maintains that the application of international law as the proper law of state contracts may lead to the same result as sought by the theory of *grundlegung*.<sup>102</sup> Dupuy seems to equate contracts which have international law as their proper law to contracts rooted in the international legal order. His quotations from Mann seem to suggest that the latter was in favour of the distinction between the *grundlegung* and the proper law. However, what Mann seems to suggest is that the parties to a state contract may, according to the rules of private

<sup>99</sup> Böckstiegel however expresses reservation as to the latter type. He believes that both the *grundlegung* and the proper law of a contract should be international before such contract could be considered to be a "public international law contract". For his definition of such contracts see Böckstiegel, K. H., The legal rules applicable in international commercial arbitration involving states or state-controlled enterprises, In *60 Years of ICC arbitration, a look at the future*, Paris: ICC Publishing S.A. 1984, 117 at 164-169.

<sup>100</sup> *Case concerning various Serbian Loans Issued in France*, [1929] P.C.I.J. Ser.A/No.20, at 41.

<sup>101</sup> Mayer, *La mythe de L'ordre juridique de base (ou grundlegung) in Le droit des relations économiques internationales*, Paris, Levreries Techniques, 1983 pp.199-216 translation provided by Alvarez, H. *supra*, note 87 at 25.

<sup>102</sup> *Ibid.*

international law, choose international law as the proper law of the contract.<sup>103</sup>

The doctrine has not attracted much support even among supporters of the internationalisation of state contracts. It has little support in national laws and has been implicitly referred to only in a few cases.<sup>104</sup> On the rationale behind the introduction of the doctrine, Riad and El-Kosheri maintain:

If it had been shocking to claim two decades earlier that a contract can be *sans loi*, it may be less objectionable to put the old "no-law" wine into new bottles and call the same wine "basic legal order" to become attractive and gain credibility.<sup>105</sup>

#### 4.3.2 *Lex Contractus*: Qausi-International Agreements

Some Western academics, in order to delocalise state contracts and take them away from the reach of the law of the state party, have put forward the theory of qausi-international agreements.<sup>106</sup> According to this theory certain contracts of states by nature are rooted neither in municipal law nor in international law. Such contracts are concluded "on the basis of the general principle of *pacta sunt servanda* and other principles of law" and for that they are called quasi-international agreements.<sup>107</sup> They create a *lex contractus*, a "new positive legal order which governs the relations

<sup>103</sup> Mann maintains: Although normally the law of a given State will govern the State contract, precisely years ago another possible solution was suggested. It was said that a contract between a State and an alien private person could be "internationalised" in the sense of being subjected to the only other legal order known to us, namely public international law. This does not mean or was ever intended to mean that the State contract should be considered to be a treaty or should be governed by public international law in the same way as transactions between states. It simply means that by exercising their right to choose the applicable legal system the parties may make public international law the object of their choice... Similarly the fact that one party is not a state should not prevent the contract from being submitted to public international law. It would thus become subject to the mandatory rules of public international law. No mandatory law of any national system as such could touch it. If the parties desire this, why should we put any obstacle in their way? Just as by their will they can choose a given State order as their proper law, so it is their will, their choice, *founded upon and permitted by the private international law of the forum* that they may submit a contract to the law of States, to public international law (italics supplied). Mann, F. A., *The theoretical approaches towards the law governing contracts between states and private persons*, (1975) RBDI 562 at 564-5 quoted in *Texaco Award*, 53 ILR 389 at 448-9.

<sup>104</sup> *Texaco Award*, 53 ILR 389 at 466; *Revere Copper and Brass Inc. v. Overseas Private Investment Corporation* 56 ILR 258 at 272-9.

<sup>105</sup> Riad and El-Kosheiri, *supra*, note 86 at 272.

<sup>106</sup> Verdross, A., *The status of foreign private interests stemming from economic development agreements with arbitration clauses*, In *Selected Readings*, 1964, 117; also Seidl - Hohenveldern, I., *The theory of quasi-international or partly international agreements*, *supra*, note 87.

<sup>107</sup> Verdross, A., *Quasi-international agreements and international transaction*, (1964) 18 *The Yearbook of World Affairs*, 230.

between the parties.”<sup>108</sup> Therefore, the contract itself creates an original legal order. Verdross, the main supporter of this doctrine, distinguishes between administrative contracts concluded under the municipal law of the state party and quasi-international agreements which are subject to the *lex contractus* and can only be modified by the agreement of the parties or by a decision of the arbitral tribunal established following the parties’ agreement.<sup>109</sup> To be considered as a quasi-international agreement, Verdross argues, the contract should meet four main conditions: (i) it should be concluded between a treaty making organ of a state and a foreign company; (ii) it should be made in the form of an international agreement *inter pares*; (iii) disputes arising from it should be submitted to international arbitration, independent of the procedural laws of the state party, and (iv) it should be governed partly by the general principles of law.<sup>110</sup>

According to this doctrine, parties acquire their rights from a legal order different from that of the state party, therefore, they may not be affected by a change of the State’s municipal law. On the other hand, although there might be a coincidence between the general principles of the *lex contractus* and those of public international law, it differs from the latter in that the *lex contractus* does not recognise some rules of public international law such as recognition of a states’ right to affect property rights in the forms of expropriation and nationalisation. Therefore, when the applicable law is public international law, the agreement may not be considered as a quasi-international one. The contracting state in a quasi-international agreement renounces its “rights to proceed to an expropriation of certain alien interests” and thus it gives more protection to the private party.<sup>111</sup>

One objection to the doctrine is that the system of law from which the contract derives its validity is unclear.<sup>112</sup> Any contract should have a system of law which recognises the rights of the parties to enter freely into a contract, and further recognises that contract as binding between the parties; it is argued that the “contract, being a

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<sup>108</sup> *Ibid.* at 234.

<sup>109</sup> *Ibid.* at 236.

<sup>110</sup> *Ibid.* at 235.

<sup>111</sup> *Ibid.* at 236.

<sup>112</sup> Mann, F. A., *The theoretical approaches towards the law governing contracts between states and private persons*, *supra*, note 103, *Passim*; Giardina, A., *State Contracts: National versus international law?*, (1980-1981) 5 *Italian Yearbook of International law* 147 at 155.

particular social-economic relationship based on the agreement of the parties, is not in itself a law-creating process unless considered as such by a legal order."<sup>113</sup> To remedy this shortcoming, proponents of the doctrine argue that the system of law from which the contract derives its binding force is the general principles of law including the main principle of *pacta sunt servanda*.<sup>114</sup> This however could lead to another question as to whether the general principles of law form an independent system of law.<sup>115</sup> Furthermore, if each quasi-international agreement forms a separate legal order, Kojanec observes that "an infinite multiplicity of legal systems should be recognised as possible; all would be original and dependent exclusively on the will of the entities creating them. Therefore, law would be represented by a set of values not necessarily connected with a social structure possessing certain characters."<sup>116</sup> Due to such theoretical problems, the doctrine of quasi-international agreements has received little support in the national laws concerning international commercial arbitration, in international conventions, or in the rules of intentional arbitration institutions. The doctrine rarely has been referred to in arbitral awards.<sup>117</sup> The arbitral tribunal in *Aramco* strongly rejected the doctrine arguing that:

"It is obvious that no contract can exist in *vacuo*, i.e. without being based on a legal system. The conclusion of a contract is not left to the unfettered discretion of the parties. It is necessarily related to some positive law which gives legal effects to the reciprocal and concordant manifestations of intent made by the parties...Human will can only create a contractual relationship if the applicable system of law has first recognised its power to do so."<sup>118</sup>

The doctrine of quasi-international agreement is clearly biased against state parties. Not only does it deprive the state party from the application of its laws to contracts closely connected to its territory and of great importance with regard to the interest of the public, it also denies the state one of its inalienable rights under international law

<sup>113</sup> Kojanec, G., The Legal Nature of Agreements Concluded by Private Entities with Foreign States, *supra*, note 14 at 322.

<sup>114</sup> Seidl - Hohenveldern, *supra*, note 87.

<sup>115</sup> Friedmann expressed the view that the theory of *lex contractus* is another way of expressing the internationalisation as a "reference to general principles of law or to natural law, or to principles of good faith and equity..." Friedmann, In *Colloquium on International Trade Agreements*, *supra*, note 14 at 361.

<sup>116</sup> Kojanec, *ibid.* at 326-7.

<sup>117</sup> *Elf Aquitaine Iran v. National Iranian Oil Company*, (1986) XI YBCA 97 at 100.

<sup>118</sup> *Aramco Award* (1963) 27 ILR 117 at 163.

namely the right to nationalise.<sup>119</sup> The introduction of the doctrine indicates how far from the principles of public and private international law some of the arguments for the delocalisation of state contracts can go, in order to exclusively protect private parties' interests to state contracts. The theory, which was formulated by a small number of writers, as one commentator puts it, has now been committed to oblivion.<sup>120</sup>

#### 4.3.3 Public International Law

It is argued that the "increasing fusion of private and public law" has led to the expansion of international law through the adoption of the customs and principles of private law.<sup>121</sup> International law, being in principle an interstate law, also contains rules concerning contractual matters; they relate to state contracts which by their nature are claimed to be "public international law contracts".<sup>122</sup> On the other hand, private international law "has been transformed from a choice of law system to a set of material rules that regulate transnational dealings and activities, the transformations in the global community and the economic interdependence of states have rendered the concept of territoriality obsolete."<sup>123</sup>

Following an expansion in the subjects of international law, which now includes international organisations and individuals in the field of human rights, states are no longer the sole subjects of international law. A case is made for the inclusion of corporations in the list of the subjects of international law with a limited international legal personality.<sup>124</sup> It is argued that a state by agreeing to the governance of international law to its contract with a private party bestows on the latter "international

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<sup>119</sup> The theory has been considered as similar to the international cartel law which at one point became a kind of "legal empire of its own between the various international companies." Friedmann, In *Colloquium*, *supra*, note 14 at 361.

<sup>120</sup> Delaume, G., The proper law of State Contracts and the *Lex Mercatoria*: A Reappraisal, (1988) 3 ICSID Rev.-FILJ 79 at footnote 4.

<sup>121</sup> Friedmann, in *Colloquium, International Trade Agreements*, *supra*, note 14 at 361.

<sup>122</sup> Böckstiegel, K. H., The legal rules applicable in international commercial arbitration involving states or state-controlled enterprises, *supra*, note 99 at 166.

<sup>123</sup> Carbonneau, The Remaking of Arbitration, *supra*, note 7 at 8.

<sup>124</sup> Friedmann, W., *Changing structure of international law*, London:Stevens and Sons 1964 at 221-31.

personality for purposes of particular contractual relations.<sup>125</sup> This personality, particularly in the context of investment agreements, is claimed "to enable the foreign investor to assert its contract rights against the contracting state at international law".<sup>126</sup> This could result in the international responsibility of state being engaged directly by the private corporation with no need for intervention by its respective state. Any attempt by the state party to change the terms of the contract affecting its obligations could amount to a breach under international law *per se*. This, in turn, could result in the availability of the remedies of international law including restitution to the private party.<sup>127</sup>

Arbitrators dealing with disputes arising from such contracts, in the absence of a choice of law by the parties, may apply public international law as the substantive law of such contracts.<sup>128</sup> In particular, the nature of the agreement as an economic development agreement and the inclusion of stabilisation and arbitration clauses have been considered as grounds for the internationalisation of state contracts.<sup>129</sup> Considering the fact that international law has rules concerning the property rights of aliens, the question is posed as to why public international law could not extend its rules to contractual aspects of relationships between foreign investors and States? Curtis finds the answer in the affirmative:

The international law of contracts builds on the law of state responsibility for injuries to aliens. That body of law has always recognised actions for breach of contract... The new international law of contracts refines this aspect of State responsibility and defining the States's international obligations by reference to the terms of the contract. While the traditional doctrine has been that a State's nonperformance of its contract is not by itself an international wrong, and that some additional element is necessary, a State's nonperformance of its obligations under an agreement governed by international law "directly and immediately gives rise to state responsibility."<sup>130</sup>

Below, major arguments advanced in favour of internationalisation of state contracts will be examined. Furthermore, on the argument based on the analogy drawn between

<sup>125</sup> Schwarzenberger, G., *Foreign investment and international law*, London:Stevens and sons 1969 at 5-6; Böckstiegel, The legal rules applicable, *supra*, note 99 at 166-167.

<sup>126</sup> Curtis, C., The legal security of economic development agreements, (1988) 29 Harvard International Law Journal 317 at 342.

<sup>127</sup> *Texaco Award*, 53 ILR 389 at 497-510.

<sup>128</sup> *Ibid.*

<sup>129</sup> *Texaco Award*, 53 ILR 389 at 450-7; Also in Lillich, R. B., The Law Governing Disputes Under Economic Development Agreements: Reexamining The Concept of "Internationalisation", In *International Arbitration in 21<sup>st</sup> Century*, 1994.

<sup>130</sup> Curtis, *supra*, note 126 at 342-3( footnotes omitted).

corporations party to state contracts and international organisations as regards their international status, it should be mentioned that there are certain features in the way international personality was conferred upon organisations and individuals.<sup>131</sup> For one thing, states consent to the new status and rights of individuals and international organisations through international conventions and treaties. Moreover, from the claim that a state can unilaterally confer upon the private party international personality it would logically follow that this unilateral act is not "governed by the principle of *pacta sunt servanda* since it is not a *pactum* and consequently the recognition can also be unilaterally abrogated."<sup>132</sup> Corporations having obtained international status would be able to engage international responsibility of states in the case of a breach of contractual obligations by the state party. There would be no equivalent right for a state viz-a-viz a private party when such a party is in breach.<sup>133</sup> A study of the literature in the field shows no substantival support in favour of the existence of a rule of international law conferring on corporations an international legal personality.<sup>134</sup> Shaw addresses the question in the context of the efforts made to introduce a code of conduct for transnational corporations on the international plane and its impact on the status of such corporations in international law:

What has been sought is a set of guidelines governing the major elements of the international conduct of these entities. However, progress has been slow and several crucial issues remain to be resolved, ranging from the legal effect, if any, of such a Code to the applicable tests for nationalisation and compensation. Should such a Code come into effect containing duties directly imposed upon transnational corporations, as well as rights ascribed to them as against the host state, it would be possible to regard them as international persons. This, however, has not yet occurred.<sup>135</sup>

Apart from the above, it is strongly doubted whether international law contains the elaborate rules necessary for dealing with the complex questions raised in the context

<sup>131</sup>Toope, *supra*, note 25 at 86.

<sup>132</sup>Peter, W., *Arbitration and renegotiation of international investment agreements*, Martinus Nijhoff 1986, 102-103; Amerasingh, State breaches of contracts with aliens and international law(1964) AJIL 881 at 898-9.

<sup>133</sup>Toope, *supra*, note 25 at 88. He further argues that the utilisation by individuals and international organisations of the rights granted to them in international law usually result in the promotion of human rights and duties which are absent in the process of corporations becoming subject of international law. *Ibid.*

<sup>134</sup>Shaw, *International Law*, Cambridge: Grotius 1991, 171-2; Brownlie, *Principles of Public International Law*, 4th edition, Oxford: Clarendon Press 1990, 68.

<sup>135</sup>Shaw, *ibid.*

of contracts to which one party is from private law.<sup>136</sup> In this context, it has been maintained:

“... as a practical matter, it is doubtful whether international law contains the essential provisions to govern State contracts. Some of the suggested principles of international law suitable for application to State contracts include *pacta sunt servanda*, *rebus sic stantibus*, respect for acquired rights, unjust enrichment, and abuse of rights. These principles, however, speak on such a high level of abstraction as to be difficult to apply in real cases... International law lacks an elaborate system of rules to graft flesh on these skeletal principles. Affirming the unsuitability of international law for application in State contract disputes, M. Wolff queries: “What is the influence of mistake [in international law]? Does it render the contract void or voidable or neither? Is a set-off allowed and in what circumstances? ... International law gives no answer to such questions.”<sup>137</sup>

As a source of international law, the ability of the general principles of law to provide such rules is also doubtful.<sup>138</sup>

### *Choice of Law Clauses*

There have been few choice of law clauses referring solely to public international law. More commonly, reference has been made to public international law as a supplement to a particular municipal law or as one among a mixture of different laws. In *Texaco*, the sole arbitrator, interpreting a clause providing for the application of the principles of the law of Libya common to the principles of international law, and in the absence of such common principles the general principles of law, held that the governing law was “international law,” rather than the general principles of law, and that Libyan law would apply only to the extent that it was consistent with international law.<sup>139</sup>

In the *ELF arbitration* the arbitrator pursuant to a choice of law clause which provided for the application of “equity and generally recognised principles of law and in particular international law” applied international law as the sole governing law of the agreement.<sup>140</sup> The arbitrator endorsed the concept of internationalisation by maintaining that the parties’ choice of law coincided “with the law that, in the absence

<sup>136</sup> Redfern and Hunter, *supra*, note 4 at 107.

<sup>137</sup> Chukwumerije, *supra*, note 4 at 162 (footnote omitted).

<sup>138</sup> See, *infra*, 4.3.4.

<sup>139</sup> *Texaco*, 53 ILR 389 at 452-3.

<sup>140</sup> *Elf Aquitaine Iran v. National Iranian Oil Company*, (1986) 11 YBCA 97 at 99-101.

of the choice of law clause, would have been the proper law of the agreement.<sup>141</sup>

Therefore, the arbitrator implied a presumption in favour of the application of international law as the applicable law in the absence of a choice of law by the parties. This view does not appear convincing as contrary argument may be advanced in favour of a presumption in favour of the application of the state party's law in contract containing no choice of applicable law.<sup>142</sup> Furthermore, the presumption in favour of the state law is further supported by the general principles of private international law applicable to such cases.<sup>143</sup> As mentioned above, as well as the choice of law, a number of other clauses of the contract and its nature have been considered as a evidence of internationalisation.

### *Stabilisation Clauses*

The inclusion of stabilisation clauses into contracts is sought by private parties to state contracts, usually investment agreements, in order to eliminate the possibility of the subsequent modification of the legal regime of the contract. The underlying reason for a state to agree to such stabilisation clauses is its need for foreign capital and expertise. A state's acceptance is also in consideration for the risk that the private party assumes by committing its capital and expertise.<sup>144</sup> The function of a stabilisation clause is to "freeze" the legal regime of the contract so that subsequent changes to the

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<sup>141</sup> *Ibid.* at 99.

<sup>142</sup> The latter presumption enjoy's the support of the statement of the Permanent Court of International Justice in the *Serbian Loans Case* according to which any "contract which is not a contract between States in their capacity as subject of international law is based on the municipal law of some country." PCIJ Ser. A, No 20 at 41.

<sup>143</sup> See below at 131; The tribunal in *Wintershall v. Qatar* held: In the absence of a controlling choice of substantive governing law clause and in consideration of the close link of ... the EP SA ... to Qatar, the governing substantive law shall determine that it is relevant to an issue, public international law. The Tribunal, after reviewing the deposited authorities on public international law, has determined that public international law is not independently relevant to the issues before the Tribunal ..." (1990) XV YBCA 30 at 34.

<sup>144</sup> *Ibid.* at 456.

law could not affect the contractual rights of the parties.<sup>145</sup> In other words, it attempts to create a "legal enclave" for the contract.<sup>146</sup> It is argued that the inclusion of a stabilisation clause is an indication of the parties' intention to remove the contract from the reach of national law and to subject it to international law or to "internationalise" it.<sup>147</sup> Here, as noted above, it is claimed that unlike the situation under traditional international law that does not consider a state's non-performance of its contractual obligations as an international wrong *per se*, the state's international responsibility is engaged as soon as a non performance has occurred.<sup>148</sup>

The legal force of stabilisation clauses should be considered first in the light of the applicable law of the contract of which the clause is a part.<sup>149</sup> From a conflict-of-laws point of view, as long as the contract is rooted in a national legal system, whether or

<sup>145</sup> Stabilisation clauses should be distinguished from intangibility clauses which require that any future modification in the regime of the contract should be mutually agreed upon by both sides. Peter, *supra*, note 132 quoting Weil, P., *Les clauses de stabilisation ou d'intangibilite dans les accords de developpement economique*, Melanges Rosseau, 1974, 307, 307-309. There are various types of stabilisation clauses and different techniques whereby such clauses aim to achieve their objectives. A stabilisation clause may provide that any subsequent enactments would have no effects on the contract, or it might exclude only applicability of subsequent enactments which are *inconsistent* with the contract. It should be noted that the reference is always to future enactments therefore the Tribunal in *Amoco* did not consider a clause related to inconsistency between current laws and the terms of the contract as a stabilisation clause. The stabilisation clause in this case provided that "[T]he provisions of any current laws and regulations which may be wholly or partly inconsistent with the provisions of this Agreement shall, to the extent of any such inconsistency be of no effect in respect of the provisions of this Agreement" *Amoco International Finance v. Islamic Republic of Iran*, 15 Iran-US CTR 189 at 239-240. Furthermore a stabilisation clause may be in the form of the incorporation of state laws, as they stand on a specific date, into the contract. For a detailed study of the typology of stabilisation clauses see Peter, *Arbitration and Renegotiation*, 136-141; also Paasivirta, E., *Participation of States in International Contracts, and Arbitral Settlement of Disputes*, Helsinki: Lakimiesliiton Kustannus 1990, 160-165.

<sup>146</sup> Brown, *Choice of Law Provisions in Concession and Related Contracts*, (1976) 39 *Modern Law Review* 628 at 628. For example the Master Agreement between the Industrial Development Corporation of Zambia and R.S.T. Ltd. had provided that any dispute would be submitted to ICSID arbitration which would decide the case according to "the law of Zambia (including its rules of the conflict of law rules) as in force on the date of execution of the Agreement disregarding all legislation, instruments, orders, directions and court decisions having the force of in law in Zambia (other than those contemplated by this Agreement) adopted, made, issued or given subsequent to date of execution of this Agreement" *Ibid.* at 628.

<sup>147</sup> Greenwood, for instance, maintains: "the really significant factor in pointing to internationalisation is the presence in the contract of some provision by which the contracting State undertakes not to use certain of its powers. Since such a clause will usually be ineffective if the contract is governed by the municipal law of the contracting state, the inference that the contract has been internationalised may be justified as the only means of giving effect to the intentions of the parties" Greenwood, *State contracts in international law: the Libyan Oil cases*, (1982) 53 *BYIL* at 53. He further considers the presence of a stabilisation clause in both *Texaco* and *Revere* as the main factor for considering the contracts concerned internationalised. *Ibid.*

<sup>148</sup> Curtis, *supra*, note 126 at 343.

<sup>149</sup> Westberg and Marchais, *General Principles Governing Foreign Investment as Articulated in Recent International Awards and Writings of Publicists*, In *Legal Treatment of Foreign Investment: The World Bank Guidelines*. Edited by E. Shihata, Dordrecht/London: Nijhoff 1993, 337 at 349.

not its proper law is international law, the stabilisation clause could be of no value since mandatory rules of that system "may override the terms of the contract".<sup>150</sup> National legislation on economic policies providing for the exercise of expropriatory measures with regard to the property rights of foreign investors may amount to such mandatory public laws. Recognition of the overriding regulatory powers of a state party to an oil concession with regard to "good oil-field practice" by the *Aminoil award* was considered as an example of the application of such mandatory public laws.<sup>151</sup>

Furthermore, the fact that a breach of a contract containing a stabilisation clause by the state contracting party can engage its international responsibility is challenged on the ground of its inconsistency with the established law of state responsibility which in such cases would require the private party to exhaust local remedies before asking his respective government to take action at the international level.<sup>152</sup> It has also been suggested that stabilisation clauses "seek to fetter" the sovereignty of the state. This, it has been argued, may not be possible as it would be in conflict with the permanent sovereignty of state and its right to nationalise.<sup>153</sup>

Stabilisation clauses and their effect have been discussed in a number of arbitral awards. The sole arbitrator in *Texaco* considered the inclusion of a stabilisation clause in the concession agreement as a ground for internationalisation; breach of a stabilisation clause was internationally unlawful.<sup>154</sup> Therefore, a nationalisation could not prevail over a contract containing such stabilisation clauses.<sup>155</sup> The decision was

<sup>150</sup>Toope, *supra*, note 25 at 53 (footnotes omitted).

<sup>151</sup>Riad, F. and El-Kosheri, *supra*, note 86 at 284.

<sup>152</sup>Sornarajah, M., *International Commercial Arbitration*, *supra*, note 44 at 252.

<sup>153</sup>*Ibid.* at 252. See also Chowdhury, S., Permanent Sovereignty and its Impact on Stabilisation Clauses, Standard of Compensation and Co-operation, In *Permanent Sovereignty over Natural Resources in International Law*, Edited by K. Hossain and S. Chowdhury, London: Frances Pinter Publishers Ltd. 1984, 42; de Archaga, J., *International Law in the Past Third of the Century*, (1981) 159 RCADI 1 at 297; The Tribunal in *AGIP* however believed that such clauses "do not affect the principle of its [Government's] sovereign legislative and regulatory powers" "These stabilisation clauses, freely accepted by the Government, do not affect the principle of its sovereign legislative and regulatory powers, since it retains to those, whether nationals or foreigners, with whom it has not entered into such obligations, and that, in the present case, changes in the legislative and regulatory arrangements stipulated in the agreement simply cannot be invoked against the other contracting party. *AGIP v. Popular Republic of the Congo*, 67 ILR 318 at 338.

<sup>154</sup>*Texaco Award*, 53 ILR 389 at 466-7.

<sup>155</sup>*Ibid.* at 479.

followed by the tribunal in *AGIP* to a great extent when it found such nationalisation illegal under international law as it was contrary to the stabilisation clause:

The application of international law in the present case therefore does not require an examination of the other possible violations of that law alleged by AGIP, particularly those concerning the discriminatory nature of the contested measures. It is sufficient to focus the examination of the compatibility of the nationalisation with international law to the stabilisation clauses.<sup>156</sup>

The sole arbitrator in *Liamco*, an arbitration with facts similar to those of *Texaco*, did not consider the stabilisation clause as preventing the state's exercise of its right to nationalise. He regarded property rights including the "incorporeal property of concession rights" as "inviolable ... subject to the requirements of its social function and public well being"<sup>157</sup> Nationalisation of such rights is not unlawful and would only constitute "a source of liability to compensate the concessionaire for said premature termination of the concession agreements."<sup>158</sup> The third Libyan nationalisation case i.e. *BP* did not consider the question of the lawfulness of nationalisation directly in relation to stabilisation clause; the arbitrator was content to characterise the nationalisation as a "fundamental breach" of the Agreement.<sup>159</sup> In the words of the award: "... the taking by the respondent of the property, rights and interests of the Claimant clearly violates public international law as it was made for purely extraneous political reasons and was arbitrary and discriminatory in character..."<sup>160</sup> Therefore, by considering the acts as arbitrary and discriminatory, the arbitrator did not have to go further to find other grounds, including a breach of the stabilisation clause, to find the nationalisation unlawful.

The majority of the Tribunal in *Aminoil* did not regard a nationalisation of the American Oil Company by the Government of Kuwait as unlawful although there had been a stabilisation clause in the concession agreement.<sup>161</sup> The Tribunal, despite the existence of stabilisation clauses in the concession agreement, decided that the law of Kuwait was the applicable law and that public international law, and general principles

<sup>156</sup> *AGIP Award*, 67 ILR 318 at para. 87.

<sup>157</sup> 62 ILR 140 at 196-197.

<sup>158</sup> *Ibid.*

<sup>159</sup> 53 ILR 297 at 329.

<sup>160</sup> *Ibid.*

<sup>161</sup> *Aminoil*, (1982) 21 ILM 976 at 1025-26; Commentary see Tschanz, P., The contribution of the Aminoil Award to the law of states contracts, (1984) 18 International Lawyer 243 at 274-6; Mann, F. A., The Aminoil arbitration, (1983) 54 BYIL 213 at 257-59.

of law, applied as part of the Kuwaiti law.<sup>162</sup> Thus, the presence of stabilisation clauses was not considered as a ground for a presumption in favour of internationalisation of the contract. The arbitral tribunal in *LETCO* having confirmed the value of stabilisation clauses declared *obiter* that they did not prevent states from enacting nationalisation laws as long as there were provisions for the payment of compensation.<sup>163</sup> The Tribunal, despite the existence of a stabilisation clause in the contract, held that the Liberian law applied.<sup>164</sup> A similar conclusion was reached by the tribunal in *Wintershall v. Qatar*.<sup>165</sup> The dispute related to a production sharing agreement which included a stabilisation and an arbitration clause. The Tribunal held that in the absence of the parties' choice of substantive governing law clause and in consideration of the close links of the contract with Qatar, the governing law should be the law of Qatar and, in case the Tribunal should determine that it is relevant to an issue, public international law.<sup>166</sup>

It would appear that stabilisation clauses in relation to the power of states to modify or to terminate their contract have been mainly considered in the context of the nationalisation of property and contract rights of foreign investors. In this context, the prevailing view is that, on the ground of public interest and subject to the conditions set by international law and the applicable law, there could be a valid termination of the contract. In a number of awards the presence of stabilisation clauses influenced the

<sup>162</sup> The Tribunal stated: "It can hardly be contested but that the law of Kuwait applies to many matters over which it is the law most directly involved. But this conclusion, based on good sense as well as law, does not carry any all-embracing consequences with it, -and this for two reasons. The first is that Kuwaiti law is a highly evolved system as to which the Government has been at pains to stress that "established public international law is necessarily a part of the law of Kuwait"(GCM paragraph 3.97(5)). in their turn the general principles of law are part of public international law... and that this specifically applies to Kuwait oil concessions, duly results from the clauses included in these. For instance, in the 1973 Agreement... the following provision is to be found:

"The parties base their relations with regard to the agreements between them on the principle of goodwill and good faith. Taking account of the different nationalities of the parties, the agreements between them shall be given effect, and must be interpreted and applied, in conformity with principles common to the laws of Kuwait and of the State of New York, United States of America, and in the absence of such common principles, then in conformity with the principles of law normally recognised by civilised states in general, including those which have been applied by international tribunals. *Aminoil*, (1982) 21 ILM 976 at 1000.

<sup>163</sup> *Liberian Eastern Timber Corporation (LETCO) v. Republic of Liberia*, 1986. (1987) 26 ILM 647 at 666-7.

<sup>164</sup> *Ibid.* at 658.

<sup>165</sup> *Wintershall A.G. et al. v. Qatar*, (1988) 28 ILM 795.

<sup>166</sup> *Ibid.* at 802.

decision on the question of compensation.<sup>167</sup> Whether stabilisation clauses "bolster the requirement of just compensation"<sup>168</sup> or they may be used as "effective bargaining argument[s] with a view to arbitration"<sup>169</sup>, one thing is clear and agreed upon by many writers and arbitral tribunals; namely that such clauses cannot guarantee absolute stability of the contract regime through its internationalisation.<sup>170</sup>

### *Economic Development Agreements*

The assertion that so-called economic development agreements form a separate category of state contracts which are automatically internationalised has been strongly challenged by academic lawyers and has lost support in arbitral practice.<sup>171</sup> Dr. Pogany in his recent comprehensive study of the topic has come to the conclusion that:

Despite the emphatic terms in which the concept of EDAs has been advanced in a number of arbitral awards and in the writing of various publicists, the doctrine rests on the most insubstantial foundations... there is little state practice to confirm the doctrine of EDAs, while the concept has received only limited support in arbitral awards and in the writing of publicists. Thus, a recent commentator has noted that "although the notion of an 'economic development agreement' has been relied on in some awards they provide hardly any legal authority in support of it and in the great majority of cases no reliance is placed thereon."

Thus, the growing practice of localising state contracts, together with substantial support for the doctrine of permanent sovereignty over natural resources, combined with the numerous arbitral awards rejecting the notion of long term development agreements as an internationalised form of state contract would seem to leave little scope for recognition of the concept of EDAs.<sup>172</sup>

<sup>167</sup> Judge Jimenez de Arechaga, maintains that stabilisation clause could not deprive the state from its power to modify the contract but instead creates a "special right to compensation" for the private party. De Archaga, *supra*, note 153 at 307; also Paasivirta, *supra*, note 145, Chapter 7 esp. Conclusions.

<sup>168</sup> Peter, *supra*, note 132 at 145.

<sup>169</sup> *Ibid.*

<sup>170</sup> "There is a general consensus... that a stabilisation clause does not render the contract immune to any subsequent changes or guarantees that it will not be amended or terminated." Westberg and Marchais, *supra*, note 122 at 349. Redfern and Hunter remark: "Stabilisation clauses, like provisions which seek to freeze the law, attempt to maintain a particular legal regime in existence, often for a considerable period of time, irrespective of any changes which may occur in the political, social and economic environment of the country concerned. Such clauses attempt, unrealistically, to create the palace of the sleeping beauty- *la belle au bois dormant*- in which time stands still." Redfern and Hunter, *supra*, note 4 at 105-106.

<sup>171</sup> The theory was considered as the sole basis of internationalisation of the agreement in *Revere Copper & Brass, Inc. v. Overseas Private Investment Corp. (OPIC)*, 56 ILR 258. A recent conditional endorsement of the theory can be found in Lillich, R. B., *The Law Governing Disputes Under Economic Development Agreements*, *supra*, note 129; For a critical view of the theory see Pogany, I., *Economic Development Agreements*, (1992) 7 ICSID Rev-FILJ. 1; Paasivirta, *supra*, note 145 at 104; Geiger, R., *The Unilateral Change of Economic development Agreements*, (1974) 23 ICLQ 73; Toope, *supra*, note 25 at 81-3.

<sup>172</sup> Pogany, *ibid.* at 20 (footnotes omitted); Toope finds the concept of EDAs 'illogical' and 'dangerous' as the application of international law to such state contracts "would become dependent upon the overall economic situation of the state party". He further quotes Teson who maintains "It [the theory of EDAs] implies that an oil concession contract between, for example, a Saudi investor and the British government would be subject to British law, while a similar contract between the Saudi government and a British investor would benefit from the protection of international law Toope, *ibid.* at 82 (footnotes omitted).

### *Arbitration Clauses*

It has been argued that recourse to arbitration has been regarded as another indication of the parties' intention to internationalise their contract;

Another process for the internationalisation of a contract consists in inserting a clause providing that possible differences which may arise in respect of the interpretation and the performance of the contract shall be submitted to arbitration.... as regards the law applicable to the merits of the dispute itself, the inclusion of an arbitration clause leads to a reference to the rules of international law.<sup>173</sup>

This claim does not necessarily correspond with reality since often the parties' recourse to arbitration is to avoid the jurisdiction of domestic courts. Many investment agreements contain both an arbitration clause and a choice of law clause providing for the application of the state party's law. In such agreements, an arbitration clause could clearly not be a basis for internationalisation.<sup>174</sup> Furthermore, as Chukwumerije has noted "[A]ssuming that arbitration clauses should play a role in determining the choice of law, it is not clear why such clauses should be interpreted as necessitating the application of international rather than municipal law."<sup>175</sup>

### *Iran-US Claims Tribunal*

Due to the nature of the Iran-US Claims Tribunal, referred to by its creating treaty as an international tribunal, charged with arbitrating, among other things, interstate claims, public international law constitutes a significant source of law in the Tribunal.<sup>176</sup> Furthermore, many expropriation and nationalisation claims have been decided mainly according to customary international law.<sup>177</sup>

The application of international law by the Tribunal even in the absence of a choice of law clause in the contract, cannot be regarded as internationalisation of the contract by the Tribunal since, such application of international law is authorised by the broad language of the relevant provision of the Claim Settlement Agreement. Furthermore, as it has been noted, the awards of the Tribunal are not fully coherent on the question of

<sup>173</sup> *Texaco Award*, 53 ILR 389 at 452.

<sup>174</sup> Delaume, *Myth of the lex mercatoria*, *supra*, note 11 at 84.

<sup>175</sup> Chukwumerije, *supra*, note 4 at 159.

<sup>176</sup> See Art.II (2) & (3) of the Claims Settlement Agreement regarding interstate claims.

<sup>177</sup> See, for example, *American International Group v. Islamic Republic of Iran*, 4 Iran-US CTR 96.

the applicable substantive law and are very much influenced by the particular nature of that tribunal, thus, their persuasive value are doubtful.<sup>178</sup>

### *ICSID Convention*

It has been claimed that the ICSID regime, including its choice of law provisions, provides for the internationalisation of investment agreements.<sup>179</sup> In effect, according to one interpretation, this internationalisation would entail the foreign investor being elevated to the status of a subject of international law and therefore capable of engaging the international responsibility of the state party.<sup>180</sup>

According to the ICSID regime, in the absence of a choice of applicable law by the parties, the tribunal decides the case according to the law of the contracting states and "such rules of international law as may be applicable."<sup>181</sup> Art.42 is a compromise between the two opposing sides, one pressing for the sole application of the state party's law and the other for the application of international law and consequently for the internationalisation of the contract. The interplay of the second part of the Article between state party law and international law is a matter on which there is a great deal of controversy between the supporters of the internationalisation of investment agreements and the developing states favouring the application of the municipal law of

<sup>178</sup> See the discussion of Art.V of the Claims Settlement Agreement, *supra*.

<sup>179</sup> The view is further supported by the assertion that ICSID arbitrations are procedurally detached from any municipal law and in that they regarded as "self-contained". Luzzatto, R., *International Arbitration and the Municipal Law of States*, (1977) 157 RCADI 9 at 98. In response, it is argued that the ICSID procedural system is not entirely "self-contained" since on the question of provisional measures and also as regards the execution of its awards it heavily relies on the assistance of national courts. Section 6 of Chapter IV of the Convention provides for a somewhat self-contained regime of recognition and enforcement of awards. "[T]he award shall be binding on the parties and shall not be subject to any appeal or to any other remedy except those provided for in this Convention" and "[E]ach Contracting State shall recognise an award rendered pursuant to this Convention as binding and enforce the pecuniary obligations imposed by that award within its territories as if it were a final judgment of a court in that State." However, as regards the execution of the award the position is that it "shall be governed by the laws concerning the execution of judgments in force in the State in whose territories such execution is sought." On the question of provisional measures and the need for court assistance see Delaume, G., *ICSID tribunals and provisional measures-a review of the cases*, (1986) ICSID Rev.-FILJ 392; also Lalive, P., *The first 'World Bank' arbitration [Holiday Inns v. Morocco]- Some legal problems*, (1980) BYIL 123, 132-137. Furthermore, the ICSID arbitral tribunals, unlike the Centre itself which has been established pursuant to a treaty and hence is an international organisation, does not derive its jurisdiction from a treaty or the Convention *per se* but from the further agreement of the parties to arbitration i.e. the State party and the foreign investor. Art.25(1) of the Convention.

<sup>180</sup> Broches, *supra*, note 21 at 353.

<sup>181</sup> Art. 42(1) of the Washington Convention.

the state to such contracts. The first group argue that the sound construction of this article is that international law plays a supervisory role to ensure that the state party's law is applied only as far as it is in conformity with international law, failing such conformity international law would prevail, therefore "in that sense...international law is hierarchically superior to national law under Article 42(1)."<sup>182</sup> This view has been strongly challenged by those who believe in the interpretation allowing for the application of the state party's law and in the case of any gaps, international law.<sup>183</sup> ICSID Tribunals have attached varying degrees of importance to international law in relation to the state party's law.

In *Bonvenuti et Bonfant*, a dispute relating to an agreement between an Italian firm and the Congo to build and operate a plant to manufacture plastic bottles, the arbitral tribunal in the absence of a choice-of-law clause, guided by Art.42(1) of the Convention, held that the law applicable was the Congolese law and "such rules of international law as may be applicable."<sup>184</sup> On the issue of compensation for the seizure of the company's assets, the Tribunal considered that the principle of compensation in the event of nationalisation was one of the Congolese Constitution and also is "one of the generally recognised principles of international law as well as of equity."<sup>185</sup> The effect of the applicable law on the final outcome of the case is unclear as the amount of compensation, following the parties authorisation, was decided *ex aequo et bono*.<sup>186</sup>

In *LETCO v. Liberia*, a dispute arising out of a concession agreement between LETCO and the Government of Liberia, on the question of the applicable law, the tribunal held: "... even if (leaving aside the opening words of the Concession Agreement itself) there was no express choice of Liberian law by the parties, it is plain that the tribunal must apply Liberian law to the present dispute."<sup>187</sup> The Tribunal noted

<sup>182</sup> Broches, *supra*, note 21 at 340.

<sup>183</sup> See Sornarajah, *International Commercial Arbitration*, *supra*, note 37 at 44-45; Kuusi, J., *The host state and the transnational corporation: an analysis of legal relationships*, Farnborough: Saxon House 1979, at 147.

<sup>184</sup> *Benvenuti & Bonfant v. The People's Republic of Congo*, Award of 15 August 1980, (1982) 21 ILM 740 at 752.

<sup>185</sup> *Ibid.* at 758.

<sup>186</sup> *Ibid.*

<sup>187</sup> (1987) 26 ILM 647 at 658.

that "the law of the contracting state is recognised as paramount within its territory but is nevertheless subjected to the control of international law."<sup>188</sup> The role of international law as a 'regulator' of national systems of law has been much discussed, with particular emphasis being focused on the problems likely to arise if there is divergence on a particular point between national and international law.<sup>189</sup>

In another case, however, the Tribunal decided the dispute according to the law of the State party. In *Klöckner v. Cameroon* on the question of the applicable law, in the absence of a choice by the parties in the contract, the Tribunal relying on Art.42(1) of the Convention held that "the civil and commercial law applicable in Cameroon" should "naturally" apply.<sup>190</sup> It should be noted that the law of Cameroon, due to its colonial-past is based on two legal systems, English and French, depending on the region. The Tribunal decided that there was a "duty of full disclosure to a partner" without referring to any precise legal texts, stating that it "took for granted" that this was a "basic principle of French civil law as indeed the case under other national codes which we know of".<sup>191</sup>

In *Amco Asia v. Indonesia*, a case concerning an agreement to construct a hotel, on the question of the applicable law in the absence of a choice, the ICSID Tribunal decided that according to Art.42(1) it had "to apply Indonesian law, which is the law of the Contracting state party to the dispute and such rules of international law as the Tribunal deems to be applicable."<sup>192</sup> In applying this to the issues the Tribunal, while admitting that the investment contract was different from private contracts in that the state had the right of unilateral withdrawal of its approval to the contract, rejected the analogy between the investment contracts and the concept of *contrat administratif* in French law as it did not find the latter doctrine to be a general principle of law. The

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<sup>188</sup> *Ibid.*

<sup>189</sup> *Ibid.*

<sup>190</sup> *Klöckner v. Cameroon*, ICSID Award of October 21, 1983, reprinted in (1985) X YBCAA 71; Paulsson, J., *The ICSID Klöckner v. Cameroon Award: The Duties of Parties in North-South Economic Development Agreements*, (1984) 1 *Journal of International Arbitration* 145 at 157.

<sup>191</sup> *Ibid.* The above award was later annulled on the ground that the Tribunal had not applied Art.42(1) correctly and that the duty of disclosure was not part of French law. The *ad hoc* Committee held that "only after having inquired into and established the context of the law of the state party to the dispute" recourse to the principles of international law would be appropriate. (1986) 11 YBCA 162 at 170.

<sup>192</sup> (1985) 24 ILM 1023.

Tribunal considered *pacta sunt servanda*, in general, as the governing general principle of law in this case. The Tribunal seems to have relied on principles of international law in deciding the standard of compensation and made the assertion that the *lucrum cessans* as well as *damnum emergens* were the appropriate remedies of international law for the case before it.<sup>193</sup> The act of seizure was considered an internationally wrongful act by the Government for which it could be internationally responsible.<sup>194</sup> The language used here by the Tribunal resembles that of an international tribunal deciding on the international responsibility of a state viz-a-viz another state.

The Committee which heard the annulment proceedings in *Amco v. Indonesia*, on the extent of the application of international law held that according to Art.42(1) an ICSID tribunal is authorised to apply the "rules of international law only to fill up *lacuna* in the applicable domestic law and to ensure precedence to international law norms where the rules of the applicable domestic law are in collision with such norms"<sup>195</sup> On the relation between the law of the state party and international law contained in Art.42(1), the arbitral tribunal in *Southern Pacific Properties (Middle East) Limited v. Arab Republic of Egypt* took a similar view.<sup>196</sup> Rejecting the Respondent's view that the parties had implicitly agreed to apply the law of the state party i.e. Egyptian law, the Tribunal held that "even accepting the Respondent's view that the parties have implicitly agreed Egyptian law, such an agreement cannot entirely exclude the direct applicability of international law in certain situations. The law of the ARE, like all municipal legal systems, is not complete or exhaustive, and where a lacuane occurs it cannot be said that there is agreement as to the application of a rule of law which, *ex hypothesi*, does not exist."<sup>197</sup>

It would appear that pronouncements of ICSID awards on the degree of the

<sup>193</sup> For the availability of the remedies in international law see Chapter V below.

<sup>194</sup> (1985) 24 ILM at 1026.

<sup>195</sup> *Amco Asia Corp. et al. v. The Republic of Indonesia* (Decision of the Ad Hoc Committee Setting Aside the Award Rendered on the Merits), May 16, 1986, (1986) 25 ILM 1439 at 1445-6.

<sup>196</sup> (1993) 8 ICSID Rev.-FILJ 328 at 350-353. Commentary Delaume, *The Pyramids Stand- The Pharaohs Can Rest in Peace*, (1993) 8 ICSID Rev.-FILJ 231; Craig, *The Final Chapter in the Pyramids Case: Discounting an ICSID Award for Annulment Risk*, (1993) 8 ICSID Rev.-FILJ 264.

<sup>197</sup> (1993) 8 ICSID Rev.-FILJ 328 at 351.

relevance of international law are not fully coherent. The text of Article 42(1) and the drafting history of the Convention show that it has never been the intention of the signatory states to subject investment disputes entirely to international law. As mentioned earlier, the ICSID solution represents a compromise between the positions taken in favour of the exclusive application of municipal or international law which was intentionally drafted in a rather vague language:

No dogmatic answer to this question appears possible... a chain is as weak as its weakest link, and this appears to be Article 42 of the Convention." and "...this weakness of the Convention is not accidental, but of the essence of the matter. Understandably, the draftsmen of the Convention worked on the assumption that it was not the task of the International Bank to deal with highly controversial issues of substantive international law. Equally understandably, they also wanted to succeed where their predecessors had demonstrably failed. Thus they thought it wiser to limit themselves to the more formal task of providing new procedural opportunities for those willing to avail themselves of them, and an ambiguous rule on the law to be applied by the arbitration tribunals which leaves it unsettled whether, in case of conflict, national law or international law is to prevail.<sup>198</sup>

Therefore, the Convention offers an international procedural framework within which arbitral tribunals are empowered to decide on the extent of the role played by international law in relation to the law of the state party without replacing it. However, it should be born in mind that this rather limited internationalisation of the ICSID type is permitted by a treaty and not presumed by the arbitral tribunal.

A number of recent works on the question of the applicable law of state contracts have also reached the conclusion that the law applicable is that of the state party with some relevance for international law.<sup>199</sup> El-Chiati, for instance, maintains:

Leaving aside concepts and theories, if we look at the exigencies and concrete realities of the relationship between States and private investors, it appears that practically speaking, there is no escape from recognising that the national law of the contracting State, in conjunction with extra-State laws and norms as noted below, should govern such relationship. Not only because the answer to many problems cannot be found outside the national law, but also because any system of law, to be viable, must "provide a central core of predictability" and coherence. Otherwise the essential requirement that a legal rule should apply in a uniform and sure manner will be

<sup>198</sup>Schwarzenberger, G., *The Arbitration Pattern and Protection of Property Abroad*, in *International Arbitration: Liber Amicorum for Martin Domke*, Edited by P. Sanders, The Hague: Martinus Nijhoff 1967, 313, 319-320.

<sup>199</sup> Franck, T.M., *General Course on Public International Law*, The Hague Academy of International Law, 1993, 240 RCADI 23 at 448-50; Westberg, *International Transactions and Claims Involving Government Parties: Case Law of the Iran-United States Claims Tribunal*, Washington D.C.: International Law Institute 1991, 65; Lillich, *supra*, note 129 at 93; Passivirta, *Participation of States in State Contracts*, *supra*, note 145 at 227-8; El-Chiati, *Protection of investment in the context of petroleum agreements*. (1987) 204 RCADI 9 at 144; Sornarajah, *International Commercial Arbitration: Problem of State Contracts*, *supra*, note 44 at 161.

missing.<sup>200</sup>

Paassivirta finds the argument that due to their categorisation as economic development agreements, state contracts are located in the international legal order unconvincing.<sup>201</sup> He suggests that the type of dispute should be considered as the determining factor in the question of the applicable law:

This approach is well in line with the trend of modern arbitration law which gives wide powers to arbitrators to determine the applicable substantive law- including the possibility to apply international law when appropriate. Now, most of the issues which arise with regard to State contracts can be perfectly well settled with reference to a domestic law, usually the law of the host state. Hence, international law is applied very selectively, to the issues it can bear upon (most often relating to compensation for expropriation). In this sense, it operates as the international *ordre public* which provides constraints to, and supplements, the application of the law of a host state. In short, it has a *role regulateur*.<sup>202</sup>

Lillich in his recent study of the subject, although in principle in favour of internationalisation<sup>203</sup>, in the light of recent arbitral awards, seems to have conceded that the trend is in favour of the application of state law as the governing substantive law:

Internationalisation *per se* of the kind advocated by Prof. Dupuy in *TOPCO [Texaco]* and endorsed by the arbitral tribunals in *Revere* and *Elf*- by which is meant the concept that public international law and general principles of law govern disputes under EDAs, or at least those EDAs containing arbitration and stabilisation clauses- no doubt is a concept in judicial retreat. Since the *Aminoil* award tribunals uniformly have rejected or ignored it, albeit often adopting approaches to the relevance of such law that would seem designed to achieve the same objectives. moreover, although parties exercising their right to choose the governing law of EDAs remain free to select public international law or general principles of law, thus effectively internationalising them, there is no evidence to indicate they are doing so. Indeed, a leading commentator observed a dozen years ago that "[t]he overwhelming majority of such agreements, to the extent that they contain a stipulation of applicable law, provide for the applicability of the law of the host state." Even when an EDA, as in *SPP* or *Wintershall*, contains no choice-of-law provision, arbitral tribunals now regularly look, initially if not necessarily exclusively, to host state law (italic supplied).<sup>204</sup>

From the above study, it would appear that there is no firm support for a presumption in favour of the application of international law to state contracts as governing law. Recent arbitral practice indicates a supplementary role for international law rather than as the

<sup>200</sup> El-Chiati, *ibid.* at 144 (footnotes omitted).

<sup>201</sup> Paassivirta, E., *Participation of States in International Contracts, and Arbitral Settlement of Disputes*, *supra*, note 145 at 277-8.

<sup>202</sup> *Ibid.*

<sup>203</sup> Lillich, *supra*, note 129 under Internationalisation Mark II.

<sup>204</sup> *Ibid.* at 93.

main source for the applicable rules. The main source remains the law of the state party.

On the role of international law in relation to the state law, Paasivirta argues that "it is related to the need to protect reliance on contracts in the face of a purported negation thereof through the exercise of sovereign powers."<sup>205</sup> He goes on to consider the development of an international law of contract and maintains:

There is no real barrier to the development of rules of international law relating to state contracts. Such rules would not completely oust the state's own law, but they might well control its application.<sup>206</sup>

In the note to this statement he further explains that "international law is normally applied in cases where a state has resorted to its legislative powers, whereas simple breaches of contracts can be settled by reference to a municipal law."<sup>207</sup> Therefore, the focus of this thesis is to achieve a kind of limited internationalisation. It is submitted that the question is not limited to whether or to what extent the internationalisation of state contracts is possible; it is rather related to the manner whereby such internationalisation is achieved. There is no doubt that states, through conclusion of treaties, can agree to limitations to their prerogatives with regard to contract such as their treaty obligation regarding the irrevocability of their consent to ICSID regime. The same way, states can agree on a supranational system governing their contracts. What seems doubtful is whether a set of principles referred to by a small number of arbitral awards can create an international law of contract.<sup>208</sup>

It is further submitted, save when a treaty obligation provides for the application of international law, the relevance of the latter to state contracts is through rules relating to protection of property rights of investor and expropriation.

#### 4.3.4 General Principles of Law

One method of delocalisation of substantive law is through the application of the general principles of law to the substance of the dispute. Art. 38(1)(c) of the Statute of

<sup>205</sup> Paasivirta, *supra*, note 145 at 284.

<sup>206</sup> He mentions the rule of restrictive sovereign immunity and rules of state responsibility for economic injuries to aliens as examples of rules relating to state contracts. *Ibid.* at 281.

<sup>207</sup> *Ibid.* at note 12.

<sup>208</sup> See a detailed examination of law making by arbitral tribunals in Ch. VII, *infra*.

the International Court of Justice refers to 'the general principles of law recognised by civilised nations' as a source of international law.<sup>209</sup> McNair, one of the first advocates of the application of the general principles of law to state contracts, argues that public international law *per se* may not be applicable to State contracts since only states are subjects of international law.<sup>210</sup> However, the appropriate legal system shares with public international law a common source of recruitment and inspiration, "the general principles of law".<sup>211</sup> According to his thesis, the applicability of the general principles of law depends on three circumstances: the special nature of the agreement as an economic development agreement, the fact that many host countries lack a developed system of law to deal with these particular types of transaction and the existence of an arbitration agreement.<sup>212</sup> He considers, the absence of a choice by the parties of a particular system of law as a reflection of their intention that their contract should be governed by the general principles of law.<sup>213</sup> A rather similar view was expressed by the arbitrator in *Sapphire* where in the interpretation of a contract clause providing for an obligation of the parties to carry out the provisions of the contract according to the principles of good faith and good will it was held that the agreement was governed by principles of law recognised by civilised nations.<sup>214</sup> The arbitrator considered the lack of reference to any positive law as a deliberate omission to exclude the application of the state party's law; i.e., Iranian law.<sup>215</sup>

There have been a number of awards decided on the basis of the general principles of law.<sup>216</sup> One of the early cases that referred to the general principles of law was *Sociétét Rialet*.<sup>217</sup> The dispute related to a concession agreement granted by the Ethiopian state monopoly to Société Rialet - a French company. The tribunal having

<sup>209</sup> Reproduced in Brownlie, I., *Basic Documents in International Law* (3rd. Edition), 387.

<sup>210</sup> McNair, A. D., *The General Principles of Law Recognised by Civilised Nations*, *supra*, note 34.

<sup>211</sup> *Ibid.*

<sup>212</sup> *Ibid.*, at 4 and 19.

<sup>213</sup> *Ibid.* at 10.

<sup>214</sup> *Sapphire International Petroleum Ltd. v. The National Iranian Oil Company* 35 ILR 136 at 173.

<sup>215</sup> *Ibid.* at 171-175.

<sup>216</sup> *Lena Goldfields Ltd. v. Union of Soviet Socialist Republic*, reprinted in (1950)36 Cornell L.Q.31 at 50; *Petroleum Development Ltd. v. The Sheikh of Abu Dhabi* (1952) 1 ICLQ 247; *Texaco*, 53 ILR 389.

<sup>217</sup> *Sentence arbitrale entre la Société Rialet et le Gouvernement éthiopien*, 8 *Rec. de decis. des trib. mixtes* (1928-29), 742, reproduced, in part, in Kuusi, *supra*, note 183 at 70.

considered the concession as public, in the absence of a choice of law clause and the non existence of an Ethiopian administrative law, applied generally accepted principles of European administrative laws. In *Lena Goldfields*, the choice of law clause of the concession had provided for the application of Soviet law insofar as special conditions were not provided by the agreement.<sup>218</sup> One of these conditions was an undertaking by the Soviet State not to alter the concession. On the question of the applicable substantive law, the arbitral tribunal agreed with the company's position that on matters within the Soviet Union, Russian law was applicable. But as for matters specifically excluded by the contract from Soviet law, the law applicable would be the general principles of law.<sup>219</sup> In *Abu Dhabi*, in the absence of a clear choice of law clause, the arbitrator did not apply the law of Abu Dhabi to the concession, on the ground that it lacked "any settled body of legal principles applicable to the construction of modern commercial instruments."<sup>220</sup> Therefore, he decided the case according to what he referred to as "principles rooted in the good sense and common practice of the generality of civilised nations- a sort of "modern law of nature."<sup>221</sup> A similar reasoning was followed by the tribunal in the Qatar case.<sup>222</sup> In *Sapphire* the dispute related to a contract between the National Iranian Oil Company and Sapphire Petroleum Limited, a Canadian company, for a joint venture in the exploration and exploitation of oil in a specified area of Iran.<sup>223</sup> The arbitrator considered the absence of a choice of law clause in the contract as a manifestation of the parties intention to exclude the application of Iranian law and to subject it to the general principles of law.<sup>224</sup> The arbitrators in *BP*<sup>225</sup>

<sup>218</sup> *The Arbitration Between the Lena Goldfields Ltd. and the Soviet Government*, (1950) 36 Cornell L.Q.42 at 50.

<sup>219</sup> *Ibid.*; see the commentary by Naussbaum, *ibid.* at 36.

<sup>220</sup> *Petroleum Development Ltd. v. The Sheikh of Abu Dhabi* (1951) 18 ILR 144 at 149.

<sup>221</sup> *Ibid.*

<sup>222</sup> *Ruler of Qatar v. International Marine Oil Company*, 20 ILR, 544. The Referee stated that a number of circumstances pointed to the law of Qatar, i.e. Islamic law, as the applicable law. But he found that that law could not govern modern concession agreements.

<sup>223</sup> 35 ILR 137.

<sup>224</sup> The Tribunal stated: It is quite clear ... that the parties intended to exclude the application of Iranian law. But they have not chosen another positive legal system, and this omission is on all the evidence deliberate. All the connecting factors cited above point to the fact that the parties therefore intended to submit the interpretation and performance of their contract to the principles of law generally recognised by civilised nations. *Ibid.* at 175.

<sup>225</sup> 53 ILR 297 at 329.

and *LIAMCO* considered the applicability of the general principles of law as part of the parties' agreement on the question.<sup>226</sup>

The general principles of law may form the basis of an award as a constituent part of international law<sup>227</sup> or the *lex mercatoria* when they have been designated by the parties or determined by the arbitrator as the applicable substantive law.<sup>228</sup>

The application of the general principles of law as the sole source of substantive rules applicable to state contracts has been strongly criticised. The critiques of economic development agreements and arbitration as grounds for the delocalisation of contracts were considered above.<sup>229</sup> The argument that the lack of a developed system of law is no longer valid since the majority of developing states, which are often parties to state contracts, have well developed legal systems capable of dealing with various contractual issues.

A common objection to the application of the general principles is based on difficulties involved in determining what constitutes those principles.<sup>230</sup> Furthermore, it is considered too unrealistic to imagine that a few mentioned rules as general principles could be capable of tackling highly complex issues raised in the context of contractual obligations, performance and so on.<sup>231</sup>

Although the general principles of law are spoken of as a set of principles, there are only certain principles which are usually emphasised, namely the principle of *pacta sunt servanda*, good faith and the principle of acquired rights.<sup>232</sup> *Pacta sunt servanda* is the cornerstone of the sanctity of contracts. It is a concept of both international and domestic law; it applies to contracts between equals in the national and international domain. The maxim has undergone a process of change both in domestic and international law. On the national level, in welfare state systems, it is a relatively common practice for the state to regulate terms of certain classes of contracts such as

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<sup>226</sup> 62 ILR 140 at 175-6.

<sup>227</sup> *Aminoil*, (1982) 21 ILM 976 at 1000.

<sup>228</sup> See, *infra*, 4.3.5.

<sup>229</sup> See, *supra*, 4.3.3.

<sup>230</sup> Redfern and Hunter, *supra*, note 4 at 114; Kojanec, *supra*, note 14 at 327.

<sup>231</sup> Redfern and Hunter, *Ibid.*

<sup>232</sup> Mustil, *The New lex Mercatoria: The First Twenty-Five Years*, In *Liber Amicorum for the Rt. Hon. Lord Wilberforce*, Edited by Bos, M. & Brownlie, I., Oxford: Clarendon Press 1987. 149 at 166-7.

consumer and employment contracts. *Pacta sunt servanda* as a general principle of municipal law is based on the concept of freedom of will in contract law. In all legal systems the notion has some limitations especially in connection with contracts between parties of unequal bargaining power.<sup>233</sup> The maxim does not enjoy the same degree of acceptance throughout the world; in particular, it is not well received in its absolute form. Protection of such paramount interest may require a degree of interference with the contractual obligations recognised by municipal law. Certainly, the level of such need is not the same in every country. It will depend on the level of the states' involvement in the economy. Therefore, it could prove difficult to draw a general principle of *pacta sunt servanda* from laws which under certain circumstances allow unilateral modification of a contract by one party.

As for the status of *pacta sunt servanda* in international law, it has faced strong challenges. There is a claim that the principle is subject to exceptions especially in the area of exploitation of natural resources where the principle of sovereignty over natural resources is now recognised by international law. Furthermore, the application of the maxim in the law of treaties is limited, among others, by the exception '*clausula rebus sic stantibus*' or changed circumstances as an implied term in the treaty providing that the treaty obligations are valid as long as the fundamental circumstances

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<sup>233</sup> See, in general, Atiyah, *Contracts, Promises and the Law of Obligations*, (1978) 94 *The Law Quarterly Review* 193-223; On the limitation of party autonomy rule see Weintraub, *supra*, note 17 at 139.

existing at the time of the conclusion of the treaty are unchanged.<sup>234</sup> Therefore, according to this doctrine there could be grounds for a party to be discharged from its treaty obligations. In the context of state contracts, it has been argued, such grounds could be changes of economic policies relating to the fundamental needs of the public interest which would amount to operating grounds for limiting effects of the doctrine *rebus sic stantibus*.<sup>235</sup>

It is also to be noted that the objective of bringing stability to the regime of state contracts by the application of the general principles of law, in particular *pacta sunt servanda*, may not be achieved as long as there could be arguments for such principles as the mutability of public contracts as a general principle of law.<sup>236</sup> It has been argued that freedom of contract and sanctity of contract are principles of the contract law of a

<sup>234</sup> Under the Vienna Convention, the scope of *pacta sunt servanda* is limited by the principle of *rebus sic stantibus* or fundamental change circumstances. According to Art. 62 of the Vienna Convention on the Law of Treaties 1969:

1. A fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless:

(a) the existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and

(b) the effect of the change is radically to transform the extent of obligations still to be performed under the treaty. The Text of the Treaty reproduced in Brownlie, I., *Basic Documents in International Law*, 3rd ed., Oxford: Clarendon Press 1983, 349. On the origin of the principle of *rebus sic stantibus*, the ILC report reads:

Almost all modern jurists, however reluctantly, admit the existence in international law of the principle with which this article is concerned and which is commonly spoken of as the doctrine of *rebus sic stantibus*. Just as many systems of municipal law recognise that, quite apart from any actual impossibility of performance, contracts may become inapplicable through a fundamental change of circumstances, so also treaties may become inapplicable for the same reason. YBILC, 1966 II p.256. The Commission however emphasised the restrictive application of the principle. It further considered that an inference of an implied term in the treaty in favour of *rebus sic stantibus* i.e. *clausula rebus sic stantibus* was undesirable "since it would increase the risk of subjective interpretation." 256.

<sup>235</sup> See Maniruzzaman, A. F. M., State Contracts with Aliens: The Question of Unilateral Change by the State in Contemporary International Law, (1992) 9 J.Int.Arb. 141 at 158-60; he quotes the following passage from *Questech Inc. v. Ministry of Defence of the Islamic Republic of Iran*, where the Tribunal considered the following as the basis of invoking the doctrine: "The fundamental changes in the political conditions as a consequence of the revolution in Iran, the different attitude of the new government and the new foreign policy, especially towards the United States which had considerable support in large sections of the people, the drastically changed significance of the highly sensitive military contracts... especially those to which US companies were parties ..."; also Avanesian, *Iran-US Claims Tribunal in Action*, Dordrecht: Graham & Trotman 1993, 108-112. *Rebus sic stantibus* has been invoked also by developed countries as a ground to impose windfall profit tax. See Hossain, K. and S. Chowdhury, Permanent Sovereignty Over Natural Resources in International Law, *supra*, note 153 at xi.

<sup>236</sup> Professor Audit maintains that both the law of treaties and different systems in the area of contract allow for a certain degree of mutability. Audit, *Transnational Arbitration and State Contracts: Finding and Prospects*, Deventer: Kluwer 1988, at 105-6. For a general study of mutability of state contracts under international and different municipal laws see Maniruzzaman, State Contracts with Aliens, *ibid*.

*lassaiz-fair* age.<sup>237</sup> In many legal systems, both principles have been qualified in the interest of the public and the weaker party to contract. The Tribunal in *Amoco Finance International* noted that "In no system of law are private interests permitted to prevail over duly established public interest, making impossible actions required for the public good."<sup>238</sup> The *Aminoil* tribunal, emphasising that it was not invoking *rebus sic stantibus*, implicitly considered the concept of mutability of the contract when it is "one of essential instrument in the economic development and social progress of a national community in the full process of development."<sup>239</sup>

Furthermore, as Professor Audit has observed "the partner invoking absolute immutability in the name of international law is claiming a protection higher than the one he would enjoy towards his own state."<sup>240</sup>

Arbitral tribunals have frequently drawn general principles from a comparative study of a few legal systems that they are familiar with and considered them as general.<sup>241</sup> Having come very often from Western industrialised nations, arbitrators are usually familiar with the legal systems of such nations. General principles so drawn may not be general enough as to encompass all the various legal systems of the world serving the different needs of nations. For example Chinese and Japanese laws do not give the same weight to the notion of *pacta sunt servanda*.<sup>242</sup> This is one reason that some commentators, in the light of the diversity of municipal laws consider only

<sup>237</sup> In this context, Atiyah maintains: "this conceptual apparatus is not based on any objective truth, it does not derive from any eternal verities. It is the result quite specifically of a nineteenth century heritage, an amalgam of classical economics, of Benthamite radicalism, of liberal political ideals of the law, itself created and moulded in the shadow of these movements. The result is that our basic conceptual apparatus, the fundamental characteristics and divisions we impose on the phenomena with which we deal do not reflect the values of our own times, but those of the last century. Atiyah, *Rise and Fall of Freedom of Contracts*, Oxford: Clarendon Press 1979, 197.

<sup>238</sup> (1987) 15 Iran-US CTR 189 at 242-3.

<sup>239</sup> *Aminoil Award*, (1982) 21 ILM 987 at (paras. 97-101)

<sup>240</sup> He further elaborates on this in the following statement: "The conception which brings down the internationalisation of the contract to a rigid application of the *pacta sunt servanda* therefore results in conferring on a private individual dealing with a state which is not his national state a degree protection which he does not enjoy in his relations with a private individual of whatever nationality, always threatened by the intervention of a mandatory rule." Audit, *Transnational Arbitration and State Contracts*, *supra*, note 235 at 105-6.

<sup>241</sup> For example, see the determination of such principles in the awards of the Iran-US Claims Tribunal where the Tribunal has usually sufficed to mention a few municipal laws as the source of its conclusion on generality of a certain principle; see in Hanessian, General principles of law in the Iran-United States Claims Tribunal, (1989) 27 Col.J.Trans'I.L. 309.

<sup>242</sup> Sornarajah, *supra*, note 44 at 142.

treaty and custom and not municipal laws as sources of the general principles of law.<sup>243</sup> Therefore, it seems unlikely that a comprehensive set of principles of such generality will be identified from a thorough examination of municipal laws.

#### 4.3.5 *Lex Mercatoria*

There is a claim for a third modern law, introduced and supported by some Western jurists, which is said to be best suited to the needs of international commerce particularly when the parties belong to different legal orders.<sup>244</sup> It has been suggested that the parties' resort to international commercial arbitration, and the fact that they did not designate the applicable law, points to their intention that the contract to be governed by the *lex mercatoria*.<sup>245</sup>

There is a difference of opinion as to the nature and sources of this third legal order. That is perhaps why it has been referred to by different names such as "transnational law"<sup>246</sup>, "transnational law of international trade"<sup>247</sup> and "international *lex mercatoria*". Although, all the mentioned concepts are based on the idea of a third legal order, their

<sup>243</sup> *Ibid.* at 135 (footnotes omitted).

<sup>244</sup> Goldman, B., The applicable law: general principles of law - the *lex mercatoria*, *supra*, note 56; Lando, O., The *lex mercatoria* in international commercial arbitration, *supra*, note 56; Thompson, D., The *lex mercatoria* in Paris and Vienna, (1983) 17 *Journal of World Trade Law* 358-365; Lalive, P., Transnational (or truly international) public policy and international commercial arbitration, In *Comparative arbitration practice and public policy in arbitration*, Edited by P. Sanders, Deventer: Kluwer 1987, 261; also a number of the contributions in Carbonneau, T., *lex mercatoria and arbitration* (ed.), *supra*, note 7.

<sup>245</sup> Lando, *ibid.* at 754.

<sup>246</sup> Jessup, P., *Transnational Law*, New Haven: 1956. The idea of a transnational law comes more from a public international law background as opposed to the *lex mercatoria* which has a private law origin. The idea, as advanced by the late Professor Jessup, is based on the assumption that the problems facing human kind are universal (transnational situations) and therefore solutions for such problems should be searched for at a transnational level (*ibid.* Ch.I). "[I]t would be the function of transnational law to reshuffle the cases and to deal out jurisdiction in the manner most conducive to the needs and convenience of all members of the international community" The fundamental approach would not start with sovereignty or power but from the premise that jurisdiction is essentially a matter of procedure which could be amicably arranged among the nations of the world (*ibid.* at 28). On the content of transnational law, Jessup maintains: "Transnational law then includes both civil and criminal aspects, it includes what we know as public and private international law, and it includes national law, both public and private. There is no inherent reason why a judicial tribunal, whether national or international, should not be authorised to choose from all of these bodies of law the rules considered to be most in conformity with reason and justice for the solution of any particular controversy. The choice need not be determined by territoriality, personality, nationality, domicile, jurisdiction, sovereignty, or any other rubric save as these labels are reasonable reflections of human experience with the absolute and relative connivance of the law and of the forum- *lex conveniens* and *forum conveniens*." *Ibid.*

<sup>247</sup> Schmitthoff, C., Nature and Evolution of Transnational Law of Commercial Transactions, In *Transnational Law of International Commercial Transactions*, Edited by N. Horn, Kluwer, at 21.

definitions of such an order are not necessarily the same. In the following the concept of the *lex mercatoria*, or law merchant, and its applicability to state contracts are studied.

According to Professor Goldman, a devoted supporter of the *lex mercatoria*, this law, regardless of its origin, is “the law proper to international economic relations;”<sup>248</sup> it is “precisely an assemblage of principles, institutions and rules from all sources, which have and still do nourish the legal structures and the legal functioning specific to the collectivity of operations in international commerce.”<sup>249</sup> Glossner defines it as “the doctrine of generally existing rules accepted by the laws of all civilised nations which ... seeks equitable solutions for transnational transactions, which otherwise remain insoluble if two or three national laws are applied.”<sup>250</sup>

On the sources and the constituent elements of the *lex mercatoria* opinion is divided between, on the one hand, those who consider the *lex mercatoria* as including transnational customary law as well as interstate laws and national laws which have international trade as their exclusive object, and on the other hand, those who consider only customary transnational law originating from customary rules which are not part of a state legal order.<sup>251</sup> Lord Mustil considers the *lex mercatoria* anational in character and therefore believes that “the fostering of the *lex mercatoria* has nothing to do with the harmonisation of international trade law”.<sup>252</sup> In identifying the rules of the *lex mercatoria*, the latter view relies both on the origin and the object of those rules. Accordingly, the *lex mercatoria* is defined as “a set of general principles and customary rules spontaneously referred to or elaborated in the framework of international trade, without reference to a particular national system of law.”<sup>253</sup> Therefore, according to this definition, it includes the general principles of law, contractual provisions such as

<sup>248</sup> Goldman, The applicable law, *supra*, note 56 at 113.

<sup>249</sup> Peter, W., *Arbitration and renegotiation of international investment agreements*, *supra*, note 132 at 94 quoting Goldman, *La lex mercatoria dans les contrats et l'arbitrage internationaux: realite et perspectives*, (1976) 106 *Journal Droit Internationale* 475 at 487.

<sup>250</sup> Glossner, O., The Influence of the International Chamber of Commerce on Modern Arbitration, In *60 Years of ICC Arbitration: A look at the Future*, 399 at 403.

<sup>251</sup> For a detailed discussion of this point see Goldman, The applicable law, *supra*, note 56 at 113-115.

<sup>252</sup> Mustil, R., *supra*, note 232 at 152.

<sup>253</sup> *Ibid* at 151 (footnote omitted).

special clauses on force majeure and hardship and arbitration awards.<sup>254</sup>

An arbitral tribunal may apply the *lex mercatoria* when the parties have chosen it as the governing law, as the law determined by the arbitral tribunal.<sup>255</sup> There have been only a few cases where the *lex* has been applied at the discretion of arbitral tribunal. Furthermore, as noted earlier in the study of national laws on the determination of the applicable law by the arbitrator in international commercial arbitration, almost all national laws require the arbitrator to make his decision according to some law; this would exclude the application of the *lex mercatoria*.<sup>256</sup>

In *Pablak Ticaret Ltd. v. Norsolor, SA*, on the question of damages for the breach of an agency agreement, relying on the international character of the contract, the tribunal chose to apply the international *lex mercatoria* and in doing so avoided 'any constraining application of a specific body of national laws'.<sup>257</sup> The tribunal decided the question of liability according to the general principle of good faith and assessed the damages in equity. The award was challenged in the courts of Austria and France on the basis that the arbitrators had decided the case in equity; that they had not been empowered by the parties to act as *amiable compositeur*; and, that there was no reference to any legal order.<sup>258</sup> Both courts rejected the challenge arguing that the tribunal, in rendering the award had not acted as *amiable compositeur*.

The French court found that, in its making of the award, the arbitral tribunal in conformity with the rules of arbitration i.e. ICC Rules had applied the law designated according to conflict-of-laws rules "that they deemed to be applicable" which in this case were "the general principles of obligations generally applicable in international

<sup>254</sup> Lando considers the existing elements of the *lex mercatoria* as public international law, uniform laws, the general principles of law, the rules of international organisations, customs and usages, standard form contracts and reporting of arbitral awards. Lando, *supra*, note 56 at 748-751.

<sup>255</sup> In *Primary Coal Inc. v. Compania Valenciana de Cementos*, the arbitral tribunal applying provisions of Art.1496 of the French New Code of Civil Procedure, decided the case on the basis of the *lex mercatoria*. An Action to set aside the award by Valenciana on the ground of its lack of conformity of the award with the Terms of reference regarding the question of applicable law was rejected. Award of 1 September 1988, published in (1990) *Revue de l'arbitrage* 701; Decision of Paris Court of Appeals, 13 July 1989, reported in (1991) XVI 137; confirmed by cour de cassation, 22 October 1991, reported in (1993) XVIII YBCA.

<sup>256</sup> The exception being French law which in Article 1496 of the Code of Civil Procedure allows the arbitrator to decide on the case on any rule which he deems appropriate. Therefore, in principle, an award made in France on the basis of national legal standards such as those made on the basis of the *lex mercatoria* are recognised in French law.

<sup>257</sup> Award of 26 October 1979, reprinted in (1984) 9 YBCA at 109.

<sup>258</sup> See (1984) IX YBCA 159-161 (Austria) and (1983) VIII YBCA at 362-365 (France).

commerce.<sup>259</sup>

The Austrian court also considered the award as being based on the general principle of good faith i.e. a general principle of law and accordingly it was not based in equity:

In this case the arbitral tribunal, by refusing to apply national conflict-of-laws rules and by invoking the *lex mercatoria*, resorted to the principle of good faith for the solution of the question regarding Claimant's liability for the damage caused to Defendant by the termination of the agency agreement. It thereby applied a principle inherent in the private law systems which in no way is contradictory to strict legal regulations of the countries here concerned.<sup>260</sup>

Another case frequently cited by the proponents of the *lex mercatoria* relates to an oil agreement between a state and its entity and an oil consortium providing for ICC arbitration.<sup>261</sup> The case between a German company and the Government of R'as Al Khaimah, a dispute relating to an oil agreement, the absence of a choice of law by the parties was interpreted as the parties' implicit will to accept the "common practice in international arbitrations" providing the application of the "internationally accepted principles of law governing contractual relations" as the law applicable to the merits of the case.<sup>262</sup> It is, however, to be noted that the case was decided on the facts and therefore, the question of the choice of law was of little significance.

The proponents of the *lex mercatoria* and some arbitral awards emphasise the claim that the *lex* is the law of the international business community and therefore they imply that it is universally accepted by all participants in international trade. Considering the size of the business community which includes members coming from diverse backgrounds and following different business laws and practices, the claim seems questionable.<sup>263</sup> The awards which have applied the principles of the *lex mercatoria*, as in the case of awards based on the general principles of law, never really

<sup>259</sup> French Decision, *ibid.*; a similar conclusion was reached by the court in the *Fougerolle v Banque de Proche Orient*, Decision of Court de Cassation December 9, 1981, [1982] *Revue de l'arbitrage* 193 cited in Goldman, *The applicable law*, *supra*, note 56 at 119-120.

<sup>260</sup> (1984) 9 YBCA at 160; Mustil, however, believes that this decision should not be considered as an endorsement of the *lex mercatoria* so much as a recognition of a court's limited powers where a tribunal's reasoning is under attack" as there was "no evidence that the application of equity contradicted any statutory imperative of" the relevant laws. *supra*, note 213 at 170.

<sup>261</sup> *Deutsche Schachtbau- und Tiefbohrgesellschaft m.b.H. et al. v. The Government of R'As Al Khaimah and the R'As Al Khaimah Oil Company (Rakoil)*, Award of 1982, (1989) XIV YBCA 111.

<sup>262</sup> *Ibid.* at 117.

<sup>263</sup> See Reisman, M., *Systems of Control in International Adjudication and Arbitration*, Durham/London: Duke University Press 1992.

substantiated the communality of such principles.<sup>264</sup>

There are only a few rules and principles usually cited by the proponents of the *lex mercatoria* and arbitral tribunals mainly *pacta sunt servanda* and the principle of good faith.<sup>265</sup> It is argued that this limited number of principles, no matter how cogent in their context, are not suited to the complex legal setting whose needs are met by such a "legal instrument" which is designed to achieve a wide range of quite detailed social and economic objectives.<sup>266</sup>

Awards of arbitral tribunals are claimed to form a major source of the *lex mercatoria*. However, despite the large volume of literature written by the supporters of the *lex mercatoria*, there have been only a handful of arbitral awards which were decided according to the *lex*. These awards have made no significant contribution to the elaboration of the theoretical basis and definition of this concept.

One major objective and also result of the introduction of any law is the promotion of "certainty" and thereby "predictability" in the subject area covered by that law so that those concerned would be aware of the eventualities of coming under the coverage of that law. The *lex mercatoria* or law merchant being a law covering international business activities is no exception as "certainty" is an essential element of any secured international business transaction. However, as will be seen, the *lex mercatoria* fails in promoting these important elements.

Law merchant is to cover all different aspects of such transactions and, therefore, should not be limited to the stage when there is a dispute between the parties. As mentioned, arbitral tribunals are considered one of the main sources of development of the *lex mercatoria*. However, they can only act when there is already a dispute. Therefore, the decision of the arbitral tribunal is tailored to solve a particular dispute and is often the result of an investigation into the very specific bargain of the arbitrating parties. Such a law making process could lack the critical elements of

<sup>264</sup>Mustil, R., *The New lex Mercatoria: The First Twenty-Five Years*, *supra*, note 232 at 156.

<sup>265</sup>Lord Mustil in his treatment of the subject lists 20 principles including *pacta sunt servanda* and consider this as a "modest haul for 25 years of international arbitration." *Ibid.* at 177.

<sup>266</sup>Reisman, *supra*, note 263 at 135; The few mentioned principles hardly amount to anything since they are too general, and also they are all common to the general principles of law and therefore no reason to reintroduce them as principles of the *lex mercatoria*. That is perhaps why it is argued that the few awards made on the basis of the *lex mercatoria* could be rationalised without having resort to that concept. See Mustil, *ibid.* at 172.

“comprehensiveness” and “objectivity”. This considered together with the fact that what usually is published of an arbitral award, if anything, is only a fraction, and many awards remain unpublished, it would not be logical to try to draw rules of law<sup>267</sup> For instance, how can one be sure that the rules drawn from a few published awards containing them have not been challenged in unpublished awards?

Furthermore, as some commentator supporting the *lex mercatoria* admit, the arbitrator in trying to find the rules of the *lex mercatoria* devises rules and solutions; therefore, as such, he acts as a ‘social engineer’.<sup>268</sup> Again, the question of the lack of certainty arises here. Such a decision making process could leave a door open to arbitrary decisions which in some cases may not be open to a challenge.<sup>269</sup>

Hight, addresses the question whether the *lex mercatoria* has replaced national laws in the interpretation of transnational contracts<sup>270</sup>, and concludes:

At best, the *lex mercatoria* is only *principia mercatoria*. These *principia* are not available to parties in the way that rules of law can serve as guides to conduct in the course of performance of a contract. The *principia* are for arbitrators to use at the other end of the transaction, but they *are not for arbitrators to use in the sense of being a form of governing law. They represent a quasi-legal recognition of the rules of common sense, equity, and reasonableness that probably would have been used even in the absence of any reference to lex mercatoria* (emphasis supplied).<sup>271</sup>

It is due to such problems as mentioned above that the viability of the *lex mercatoria* as law and its superiority to national law, generally in the context of international commerce comes under question:

“...Does it [*lex mercatoria*] provide the businessman with a set of rules which is sufficiently accessible and certain to permit the efficient conduct of his transactions?...In short, has the *lex mercatoria* stolen the international commercial scene, pushing national laws into the wings? In each case, the detached observer must, I believe, be driven to answer ‘no’.”<sup>272</sup>

#### 4.3.5.1 *Lex Mercatoria* and State contracts

There have been suggestions that the *lex mercatoria* is particularly applicable to state contracts. Indeed, it is another avenue through which to take the contract away from

<sup>267</sup> For a discussion of the question of law making by arbitral tribunals see Ch. VII below.

<sup>268</sup> Lando, *supra*, note 56 at 764; See also Mann, F., The Proper law in the conflict of law, (1987) 36 ICLQ 448.

<sup>269</sup> Mann, F., Private Arbitration and Public Policy, (1985) 4 Civil Justice Quarterly 257.

<sup>270</sup> Hight, K., The Enigma of the *Lex Mercatoria*, *In Lex Mercatoria and Arbitration*, *supra*, note 7 at 99.

<sup>271</sup> *Ibid.* at 108.

<sup>272</sup> Mustil, The New *Lex Mercatoria*, *supra*, note 232 at 181.

the reach of the state party's law in order to protect the private party against any unilateral change of law by the state. The *lex mercatoria* being the law merchant is there to serve the needs of the international business community.<sup>273</sup> It is made and therefore aims particularly at protecting the interests of that community. It is further nourished by the writings of scholars sharing the same views as those of business interests. In many cases the same writers act as arbitrators, i.e. in this context direct law makers. States party to contracts, very often developing states, have not been involved in the development of this law, which is supposedly made by participants in international trade, and find its rules and principles biased against them; the mere participation of developing countries in some arbitrations could not necessarily be construed as their active participation in the law making process by arbitral tribunals.<sup>274</sup>

The process of 'law making' by arbitral tribunals, it was noted, lacked elements of "objectivity", "comprehensiveness" and hence "predictability". Such shortcomings contribute to the formation of a 'law merchant' which at times could be nothing more than the personal preference of the arbitrator for a particular solution with no connection to any law proper.<sup>275</sup> This could be extremely detrimental to the state party and the interests of the nation it represents. The process has attracted strong criticisms

<sup>273</sup> On this point, Juenger maintains: "After all, the *lex mercatoria* is a law created by an interest group for its own benefit. That autonomous creation may adversely affect outsiders... It is only fair to ask whether the new law merchant should not contain, in addition to rules grounded in expediency and self-interest, some fundamental safeguards to protect the common interest of all. Juenger, F. K., *The Lex Mercatoria and the Conflict of Laws*, In *Lex Mercatoria and Arbitration*, *supra*, note 7, 213 at 222.

<sup>274</sup> It has been argued that "The creation of a new international economic order, so often proclaimed in international fora, requires the active participation of so-called "developing countries" in the World's economic decision making centres rather than their systematic and sometimes strategic isolation. Similarly, the participation of these countries in international arbitration is necessary to develop a truly global and effective merchant law. Abandoning old ideas of veiled exploitation, most of the developing countries are now active participants in international arbitration... It is only with the participation of businessmen from all over the World that the new international law merchant will be ratified without social, geographic, racial, linguistic or economic discrimination." Cremades, B. M., *The impact of international arbitration on the development of business law*, (1983) 31 *AJCL* 526. However, considering the fact that the institution of international commercial arbitration, in principle, has evolved against a private law background within a market economy context, that the procedure is geared to the promotion of values of such system, it might be difficult for it to appreciate and adapt itself to the needs of different economies where the public law has a greater role in relation to economic transactions.

<sup>275</sup> Park describes the *lex mercatoria* as not more than a "fig leaf to hide an unauthorised substitution of [the arbitrator's] own private normative preferences for ... the properly applicable law." Park, W. W., as quoted by Mann in *Lex mercatoria and arbitration*, *supra*, note 7, introduction.

of lawyers from developing states,<sup>276</sup> and is not accepted under the ICSID regime of arbitration.<sup>277</sup>

In applying the *lex mercatoria*, it is argued, even by its proponents, that the arbitrator should take into account the mandatory laws and public interests of the countries closely connected with the contract.<sup>278</sup> Therefore, considerations of the mandatory rules of the countries whose public interest is concerned would not allow the application of the *lex mercatoria* as long as such application could be in conflict with the public interest.<sup>279</sup>

It may be true that in a state contract subject to the state law, a private party might undergo, in the extreme case, an unremedied damage due to the state party's unilateral modification or termination of the contract through a change of its law. But, as one commentator has pointed out, after all the private party would still have the hope of seeking assistance of his national state through the espousal of his claim into an international claim pressed against the state party to the contract.<sup>280</sup> What would be the second chance for a state party in an arbitration governed by the obscure rules of the *lex mercatoria* which in turn could put the state party and what it represents i.e. public interest at the discretionary decision of an arbitrator?

A presumption in favour of the application of the *lex mercatoria* in cases where private parties have left the question of the determination of the applicable law to the

<sup>276</sup> Sornarajah remarks that: "[I]t would be strange if a small group of men who monopolise the lucrative business of international commercial arbitration can pass themselves off as law-givers to the world simply through the process of repetitious awards based, not on any scientific investigation of principles, but on their good sense and preference for particular models of law." Sornarajah, *International Commercial Arbitration*, *supra*, note 44 at 147.

<sup>277</sup> According to the Convention (Art.42), failing a choice of the applicable law by the parties, arbitral tribunals should decide on the substance of the dispute according to the State law and/or international law. Thus the relevant rules will be those of the traditional systems of law, to the exclusion of the *lex mercatoria*. See Delaume, *The Myth*, *supra*, note 11 at 87-8.

<sup>278</sup> Lando, *supra*, note 56 at 766.

<sup>279</sup> On the supremacy of national interest Lando remarks: As long as they are "fair" and "reasonable", "states should help each other in the enforcement of relevant governmental policies. The arbitrator should join in this solidarity..." Lando, *ibid*, at 769; also see Carbonneau, *The Remaking of Arbitration: Design and Destiny*, *supra*, note 7 at 16-7.

<sup>280</sup> Toope, *supra*, note 25 at 94. On various possible protections normally available to foreign investors under the national law of the state party El-Chiati mentions (i) constitutional protection; (ii) protection given to private party under the regime of administrative contracts; (iii) "where some rights are granted to the investor by a law of general application protecting investments or where the contract is formalised by law, any violation of such law by the Administration would be held to be null." El-Chiati, A., *supra*, note 197 at 146.

arbitrator may seem reasonable.<sup>281</sup> States, however, must not be *presumed* to have intended to subject their contract and dispute arising therefrom to any law but their own.<sup>282</sup>

#### 4.4 Conclusions

The controversy in the context of the applicable law of state contracts focuses around the choice of such laws which would guarantee the sovereign prerogatives of unilateral alteration and termination on the one hand and those which would exclude such prerogatives on the other.

On the question of the choice of law of state contracts, in the light of the recognition of the interests of the various interested legal systems as well as particular contractual interests of the parties, a more balanced approach would appear to rest on the application of the general principles of private international law which recognises party autonomy subject to mandatory and public policy rules of the relevant national laws. In the absence of a choice of law by the parties, such principles provide for the law to which the contract has closest connections. This, in the case of state contracts which have genuine public interests ties such as foreign direct investment agreements, will result in the designation of the state party's law as the applicable substantive law.

*Ad hoc* arbitral tribunals, in the absence of a choice-of-law by the parties, have often avoided the application of the state law which, according to the general principles of private international law, would be the law applicable. The fact that the application of various theories of delocalisation of state contracts, which have been advanced by arbitral tribunals independent from any national law, would result in heavy reliance on the maxim *pacta sunt servanda* and the exclusion of the state's privileges based in its law, indicates that a heavier support is given to the protection of private interest. More specifically, the theory of internationalisation of state contracts, advocated by a number

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<sup>281</sup> Even in the case of private contracts presumption in favour of the application of the *lex mercatoria* has been strongly criticised: "This striking proposition ignores the possibility to be worth mentioning, or that the parties never thought about the matter at all. Moreover, even if the parties had in fact disagreed, there seems no warrant for inferring unanimity in favour of ruling out all potentially relevant national systems and substituting an anational system of which only the smallest minority of businessmen can ever have heard." Mustil, *supra*, note 232 at 264.

<sup>282</sup> See chapter I at 9.

of arbitral awards, aims to subject state contracts exclusively to public international law, is mainly to promote the protection of private interest to the same level as that of public interest by subjecting the contract to the rule of sanctity of treaties. As a result, the sovereign prerogatives of the state with regard to the contract will be excluded.

The one-sided support given to the protection of private interest by this theory may be compared with the choice-of-law provisions of the ICSID Convention which, in the absence of a choice by the parties, provides for the application of state law together with international law, in that the protection of the public interest of the contract is given more recognition. Largely due to their fundamental flaws, delocalisation theories have been increasingly abandoned. The position of a number of recent arbitral awards which have reaffirmed the applicability of state party's law appear more compatible with the established rules of law both at domestic and international level and hence is more commendable. As a result, the power of the state to alter or terminate the contract according to the changing demands of public interest would primarily depend on its own law. It follows that the state party's interference with its contracts are not considered as international wrong *per se*. Such interferences are more appropriately dealt with within the context of the applicable law of contract and international law relating to taking of aliens' property. On whether the right of states to take aliens' property rights can be fettered by virtue of a contractual commitment, the prevailing negative view of arbitral awards appears to be more compatible with the nature of state contracts in national laws and international law of expropriation.

With regard to the question of the determination of applicable substantive law in international commercial arbitration, a distinction should be made, on the one hand, between those national laws on arbitration which impose a duty on the arbitrator to follow a conflict of law approach, and, on the other hand, those laws which give him a higher, and sometimes uncontrolled freedom to decide on the matter. Due to their commitment to public policy requirement of the relevant national laws, arbitrations belonging to the first category appear to be relatively more compatible with the interest of the state than the latter. The more liberal and sometimes non-interventionist attitudes of a number of national laws towards arbitration have created possibilities of

delocalisation of the applicable substantive law by allowing the arbitrator to subject the contract to the rules of the *lex mercatoria*. Given the general commitment of the *lex mercatoria* to the promotion of stability of contractual relations, its sensitivity to the changing demands of public interest, which often require flexibility of contractual arrangements, is highly questionable. Therefore, the ability of arbitrations following the *lex mercatoria* to meet the changing demands of state contracts is doubtful.

## Chapter V

### Remedies

#### 5.1 Introduction

The focus of controversy with regard to the question of remedies is on a conflict between, on the one hand, the position of state parties who are in favour of such remedies which would not impede the exercise of their sovereign discretions with regard to the contract and, on the other hand, the position of private investors supporting such remedies which would uphold sanctity of the contract.

The study of substantive remedies in arbitration of state contracts involves a number of difficulties which may be appropriately considered at the outset.<sup>1</sup> Lack of sufficient theoretical work has resulted in the relative absence of literature dealing with various aspects of the subject.<sup>2</sup> Looking at the problem in the context of the remedies of international law, Gray has observed that general international law, is quite unclear; very often arbitral tribunals do not mention the source of the rule applied.<sup>3</sup> Furthermore, having observed the fact that international tribunals have often borrowed the remedies of municipal laws, she criticises such tribunals for their failure to “develop a coherent theory of the relationship between the rules of international law and those of municipal law” on remedies.<sup>4</sup> This is particularly important in cases where the questions of liability and remedies are decided separately by international law and

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<sup>1</sup> The question of remedies in the arbitration of state contracts has recently been the subject of a few studies. See Paasivirta, E., *Participation of States in International Contracts, and Arbitral Settlement of Disputes.*, Helsinki:Lakimiesliiton Kustannus (Finnish Lawyers' Publishing Company) 1990.; Toope, S., *Mixed International Arbitration: Studies in Arbitration between States and Private Persons*, Cambridge:Grotius 1990.; Sornarajah, M., *International Commercial Arbitration: Problem of State Contracts*, Singapore:Longman 1990.; Westberg, J. A., *International Transactions and Claims Involving Government Parties: Case Law of the Iran-United States Claims Tribunal*, Washington, D.C.:International Law Institute 1991.; Gray, C., *Judicial Remedies in International law.* (second edition) Oxford:Clarendon Press 1990; Bowett, D. W., *State Contracts with Aliens: Contemporary Developments on Compensation for Termination or Breach*, (1988) LIX BYIL 49-74.

<sup>2</sup> Toope, *ibid.* at 160-1.

<sup>3</sup> Gray, *supra*, note 1 at 5.

<sup>4</sup> *Ibid* at 7.

municipal law respectively.<sup>5</sup>

As will be noted below, in the context of the remedies applied, the characterisation by the arbitral tribunal of the act of state which is to be remedied plays a decisive role. Arbitral tribunals have often confused a contractual breach with a tortious or delictual act.<sup>6</sup> Many state contract disputes are related to the expropriation or nationalisation of the concession rights of foreign investors which may include both contractual and non-contractual rights. Dealing with such cases, an arbitral tribunal may have to treat the issues of remedies and the method of damage assessment separately for a contractual breach and a tortious act. The study of arbitral awards shows that such a distinction is often not made. Moreover, when the applicable substantive law is a national law, the characterisation by the arbitral tribunal of the state contract as public or private under the relevant applicable law may influence the availability of certain remedies. As will be noted below, under many national laws remedies of specific performance or restitution are not available against the state party to a public contract.<sup>7</sup>

Extra-judicial elements have often influenced the decisions of arbitral tribunals on remedies:

The nationalising state will seek an independent benediction for its policy, or it may refuse to participate in an arbitration, believing that its sovereignty is under threat. An arbitral tribunal, in deciding upon remedies, may find itself balancing its concept of justice against harsh external realities, especially the reality that it is necessary, given the inevitable difficulties with translational enforcement, to encourage voluntary compliance. This tension has been aptly described as "a never-ending war between two irreconcilable principles- the high principle which demands justice though the heavens fall, and the low principle which demands that there shall be an end to litigation". Needless to say, these considerations will not operate in the typical judicial action "in the municipal sphere".<sup>8</sup>

It is the involvement of such elements that has been the reason for considering the arbitrators's choice of a remedy as being largely "fair and equitable in the

<sup>5</sup> *Ibid* at 9-10; Meesen on the entry of domestic law concepts into international law states: "Even if the structure of the problem in both legal systems is the same or, at any rate, sufficiently similar, the prevalence of existing rules of international law has to be respected. Concepts of domestic law may not be transferred to the plane of international law insofar as their contents are contrary to elements of existing rules of international law." Meesen, K. M., *Domestic Law Concepts in International Expropriation Law*, In *The Valuation of Nationalised Property in International Law*, Edited by R. B. Lillich, Charlottesville: University Press of Virginia 1987, 157 at 161.

<sup>6</sup> Toope, *supra*, note 1 at 161.

<sup>7</sup> *Infra*, 5.3.1.

<sup>8</sup> Toope, *supra*, note 1 at 163 (footnotes omitted).

circumstances.<sup>9</sup> The involvement of such circumstances somewhat undermines the persuasive value of arbitral awards on the question of remedies.

Apart from the problems involved with respect to the availability of a particular remedy, there is the question of the quantification of damages or valuation of the property and the contract rights expropriated.<sup>10</sup> Arbitral tribunals, here, too have resorted to "equity" to modify the effect of the strict application of a chosen method and to arrive at a more "equitable" amount.<sup>11</sup> It is for such reasons that the awards of arbitral tribunals are considered not to contribute to a body of international law dealing with remedies. As Gray maintains:

Thus in international arbitral practice the question of the remedies available and the more common question of the methods of quantification of damage were left to the *discretion* of the arbitrator. And the immediate impression made by an examination of international arbitral decisions is of a chaos of conflicting decisions.<sup>12</sup> (Italic supplied)

## 5.2 Applicable Law

In principle, the question of remedies in the arbitration of a state contract dispute is decided according to the agreement of the parties and the relevant applicable laws. Thus, a primary question for an arbitral tribunal will be which law to apply to the substance of the dispute, or what is the proper law of the contract.<sup>13</sup> Furthermore, it may not be enough that the substantive law allows a certain type of remedy since in the case of an arbitration procedurally governed by a national law, that law should also recognise the remedy ordered by the tribunal.<sup>14</sup> In this sense, a national law, international law, transnational law or a set of arbitration rules could be the likely source of the remedy applied.

<sup>9</sup> See, *infra*, cases discussed under the standard of compensation and Valuation.

<sup>10</sup> Brownlie argues that the State's exercise of its executive or legislative authority to destroy contractual rights as an asset comes within the ambit of expropriation. Brownlie, *Principles of Public International Law*, 4th edition, Oxford: Clarendon Press 1990, 548.

<sup>11</sup> See, *infra*, 5.4.2.

<sup>12</sup> Gray, *supra*, note 1 at 10.

<sup>13</sup> Mann, F. A., *The Consequences of an International Wrong in International and National Law*, (1976-77) 48 BYIL 1 at 61-2.

<sup>14</sup> *Ibid.*

(i) *National laws*

National laws could be an independent source of a remedy when determined as the applicable substantive law of the contract or the governing law of the arbitration agreements or through the application of the general principles of law as part of international or translational law. A comparative study of the municipal laws on remedies points to a lack of uniformity on the primacy of certain remedies for a breach of contract; while damages are the primary remedy in Anglo-American law, according to German and Danish law specific performance is the primary one.<sup>15</sup> Furthermore, as noted in chapter I, many national laws differentiate between public and private law contracts.<sup>16</sup> Characterisation as a State contract by the applicable national law could have an essential impact on the remedy ordered by the arbitral tribunal. The public interest element involved in such contracts and its safeguard may allow the application of certain public policy rules.<sup>17</sup> More specifically, based on its discretionary powers the public authority may be in a position to vary contractual terms, or terminate the contract unilaterally, or impose sanctions against the private contractor.<sup>18</sup> In principle, since the termination of the contract in such cases is based on public policy reasons, it is not treated as a breach, and therefore it may be not remedied by specific performance or restitution in kind; compensatory damages are normally the only available remedy which could often be less than standard of full compensation.<sup>19</sup>

(ii) *International law*

According to the traditional international law of state responsibility, states are under an obligation to protect aliens' property. This obligation however is owed to the investor's state rather than to the investor himself.<sup>20</sup> Therefore, if the taking of the property of an investor is not objected to by his state of nationality or if such taking is

<sup>15</sup> For a comparative study of remedies for breach of contract see Treitel, G. H., *Remedies for Breach of Contract*, Oxford: Clarendon Press 1988; also the conclusion of the arbitrator in *BP Exploration Company (Libya) Ltd. v. The Government of the Libyan Arab Republic*, (1973) 53 ILR 297 at 348-9.

<sup>16</sup> Chapter I, *supra*, 1.2.2.1.

<sup>17</sup> See in general in Turpin, C. C., *Public Contracts*, In *International Encyclopaedia of Comparative Law*, Edited by A. Von Mehren, 1980.

<sup>18</sup> *Ibid* at 36-44.

<sup>19</sup> See *infra*, notes 169-180 and accompanying text.

<sup>20</sup> See in general Borchard, E., *Diplomatic protection of citizens abroad*. New York: Kraus 1927.

an expropriation recognised by international law, no wrong has occurred.<sup>21</sup> Despite the efforts under contemporary human rights law theory, according to which "a wrong against a person violates the rights of the injured individual giving rise to a claim which is not necessarily disposable by the State of which the person is a citizen", the traditional view is still largely adhered to.<sup>22</sup>

In the context of expropriations, the legality of the taking may affect the availability of certain remedies and the measure of compensation. Under traditional international law, any interference with an alien's property was considered to be a violation of acquired rights, which were internationally protected, and was therefore unlawful. Contemporary international law, however, recognises measures of nationalisation or expropriation as an exercise of a sovereign right of the state and therefore lawful.<sup>23</sup>

It has been argued that the taking of contract rights of an alien in breach of an internationalised contract containing a stabilisation clause constitutes an international wrong.<sup>24</sup> In such a case, *restitution in integrum* as the remedy of international law for an illegal act should be ordered. On the other hand, there is the view which does not consider a breach of state contract, through a lawful taking of the property rights of an alien, as an illegal act *per se*. According to this view, the breach would affect the amount of damages. Therefore, it would be in the interest of the alien to seek remedies for a breach of contract rather than compensation for a lawful expropriation since "the finding of a breach would lead to damages for the breach, resulting in a higher award than might be expected by way of compensation for a lawful expropriation."<sup>25</sup>

### (iii) *Transnational law*

Third legal orders, translational law in the sense of the *lex mercatoria* or otherwise, have been argued as other possible sources of substantive rules applicable to state

<sup>21</sup> Franck, *General Course on Public International Law*, (1993) 240 RCADI 23 at 466-7.

<sup>22</sup> *Ibid.* He further maintains: Indeed, much of the work currently undertaken by the International Law Commission on State Responsibility has focused on the "legal régime of the measures that an *injured State* may take against a State which committed an internationally wrongful act (italics supplied)."

<sup>23</sup> De Archaga, J., *International Law in the Past Third of the Century*, (1981) 159 RCADI 1 at 298.

<sup>24</sup> 53 ILR 398 at 438-495.

<sup>25</sup> Bowett, *supra*, note 1 at 59.

contracts.<sup>26</sup> The problems involved with the application of the rules of such sources were in general dealt with elsewhere.<sup>27</sup> As noted, the general principles of law form a major source of substantive rules in various versions of third legal orders. Since there is no uniformity among national laws on the question of remedies, *lex mercatoria* or any other unclearly-defined legal order would not offer a clear source of remedies. The designation of a third legal order as the source of remedies, in effect, would confer a good deal of discretion on the arbitral tribunal or on the arbitrator.<sup>28</sup>

(iv) *Arbitration rules:*

As to the rules of arbitration institutions and *ad hoc* arbitrations, in principle, their applicability is subject to the agreement of the parties and the permission of the relevant applicable laws, in particular, *lex arbitri*. In any case, the study of such rules points to a general lack of reference to the question of remedies.

### 5.3 Remedies in State Contracts Arbitrations

As regards the desirability of remedies, the attitude of parties to state contracts disputes is divided. On the one hand, private parties favour such remedies which effectively uphold the sanctity of contracts. On the other hand, state parties are in favour of the order of remedies which are compatible with the exercise of their sovereign prerogatives. Below, the availability of a number of remedies in arbitration of state contracts is considered.

#### 5.3.1 *Restitutio in Integrum* and Specific Performance

Technically speaking, the remedies of *restitutio in integrum* and specific performance are distinct; *restitutio in integrum* goes further than specific performance as it requires the restitution of the situation which would have existed if the illegal act had not been committed<sup>29</sup> and "it may involve the rectification of harm already caused by the illegal

<sup>26</sup> See in Chapter IV, *supra*, 4.3.5.

<sup>27</sup> *Ibid.*

<sup>28</sup> Bowett, *supra*, note 1 at 52.

<sup>29</sup> *Case concerning the Factory in Chorzów*, PCIJ Ser.A., No.13 (1928) 47.

act.<sup>30</sup> In the context of State contracts, the applicability of this remedy is a matter of controversy.

In the context of the international law of state responsibility the remedy of restitution in kind is ordered as a primary remedy for an international wrong.<sup>31</sup> Furthermore, the remedy may be ordered by virtue of the provisions of a treaty or according to the applicable municipal laws. The purpose of the remedy under international law is "to put the aggrieved party in the same position as he would have occupied if the wrongful act had not taken place."<sup>32</sup> The applicability of the remedy was considered in *Chorzow Factory* :

"The essential principle contained in the actual notion of an illegal act ... is that reparation must as far as possible wipe out all the consequences of the illegal act and reestablish the situation which would in all probability, have existed if that act had not been committed.

Restitution in kind, or, if this is not possible, payment of a sum corresponding to the value which a restitution in kind would bear; the award if need be, of damages for loss sustained which would not be covered by restitution in kind or payment in place of it- such are the principles which would serve to determine the amount of compensation due for any act contrary to international law."<sup>33</sup>

However, in the context of state contracts, restitution in kind has been rarely ordered by arbitral tribunals. The major case where the remedy was awarded was *Texaco*.<sup>34</sup> The sole arbitrator in *Texaco* having considered the contract internationalised, relied on the principle of *pacta sunt servanda* to regard the unilateral termination of the

<sup>30</sup> Gray, *supra*, note 1 at 13; elsewhere in her work she observes: "... the arbitrators in *BP* and *Topco* tended to run the two together; they do not mention their separate functions. Thus in *BP* the arbitrator discussed the precedents for restitution in international law, and those for specific performance in Libyan law. His brief justification was that: "Generally speaking, however, it is probably true to say that the discussion about *restitutio in integrum* in public international law and that concerning specific performance in the field of the general principles of law, in fact have reference to the same problem." Again in *Topco* the claimant company asked that Libya should be held to perform the Deeds of Concession and fulfil their terms. The arbitrator considered both restitution and specific performance in Libyan law as if they were interchangeable in international law; he mentioned only *restitutio in integrum*. He concluded that *restitutio in integrum* was available and made an order in terms requested by *Topco*, an order resembling specific performance rather than *restitutio in integrum*." *Ibid* at 195.

<sup>31</sup> *Chorzow Factory case*, *supra*, note 28 at 47-48.

<sup>32</sup> Redfern and Hunter, *International Commercial Arbitration*, second edition, London: Sweet and Maxwell 1991, 364.

<sup>33</sup> *Supra*, note 28.

<sup>34</sup> *Texaco*, 53 ILR 389. For commentaries of this case and other Libyan nationalisation cases see Fatouros, A., *International law and internationalised contract*, (1980) 74 AJIL 134; von Mehren, and Kourdis, *International Arbitration between states and private parties: The Libyan nationalisation cases*, (1981) 75 AJIL 476; White, *Expropriation of Libyan Oil Concessions*, (1981) 30 ICLQ; Greenwood, C., *State contracts in international law: the Libyan Oil cases*, (1982) 53 BYIL 27-81.

contract illegal under international law.<sup>35</sup> On the effect of the stabilisation clause viz-a-viz the right to nationalise, the arbitrator noted:

Thus, in respect of the international law of contracts, a nationalisation cannot prevail over an internationalised contract, containing stabilisation clauses, entered into between a State and a foreign private company. The situation could be different only if one were to conclude that exercise by a State of its right to nationalise places that State on a level outside of and superior to the contract and also to the international legal order itself, and constitutes an "act of government" ... which is beyond the scope of any judicial redress or any criticism.<sup>36</sup>

On the basis of a short survey of earlier judicial awards, the arbitrator considered *restitutio in integrum* as the primary remedy in international law.<sup>37</sup> He also found that according to Libyan law this remedy was the appropriate one in favour of one contracting party when the other party has breached its obligations.<sup>38</sup> His inquiry covered a limited number of cases not specifically related to state contracts.<sup>39</sup> The decision of the arbitrator should be seen in the light of the fact that he considered the concession as internationalised and that the act of expropriation constituted a breach of an internationalised contract and was therefore unlawful under international law. It was noted above, however, that there remains no substantial support for the theory of internationalisation of state contracts.<sup>40</sup> The availability of restitution in kind as a remedy for a breach of state contract on the basis of the cited authorities is also doubtful. In the *Chorzow Factory Case* the remedy of restitution had been provided for by provisions of a treaty. Therefore, it is argued that in the absence of such a treaty or any municipal law provision allowing for restitution there cannot be a claim for this

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<sup>35</sup> 53 ILR 389 at 479.

<sup>36</sup> The arbitrator cited *The Anglo-Iranian Oil Company* as evidence of state practice in which the Government of the United Kingdom sought restitution of a concession allegedly unlawfully expropriated. The claim was an interstate one brought before the International Court of Justice as distinct from *Texaco* which according to the arbitrator related to a state contract before an *ad hoc* tribunal. It was never decided on its merits as the Court decided that it lacked jurisdiction. ICJ Pleadings (1952) at 124. Furthermore, the reliance by the sole arbitrator on the *Temple of Preah Vihear Case* has also been criticised as it related to a territorial and cultural property dispute which due to the nature of the property in issue could not be settled unless the property was returned to its original place. Sornarajah, M., *The pursuit of Nationalised property*, Martinus Nijhoff 1986, at 142-143.

<sup>37</sup> 53 ILR 389 at 497-509.

<sup>38</sup> *Ibid* at 494.

<sup>39</sup> He cited the view of *Chorzow Factory* and *Martini, Mavrommatis Concessions*, and the *Temple of Preah Vihear*. *Ibid* at 497-509, footnotes omitted.

<sup>40</sup> *Supra*, Ch. IV.

remedy.<sup>41</sup> *LIAMCO* related to the nationalisation of the company's rights under an oil concession agreement containing choice-of-law and stabilisation clauses similar to those in *Texaco*.<sup>42</sup> The arbitrator, unlike the one in *Texaco*, did not distinguish between the nationalisation of contractual or non-contractual rights and considered them both as the nationalisation of property. The arbitrator recognised the right of states to nationalise concession rights "if not discriminatory and not accompanied by a wrongful act or conduct" subject to the requirements of compensation.<sup>43</sup> He agreed, in principle, that under the applicable law of the agreement i.e. Libyan law and international law, obligations were to be performed where possible.<sup>44</sup> The arbitrator did not order the remedy due to its impossibility and the fact that it would be an "intolerable interference" in internal sovereignty, and that the grant of the remedy presupposed the cancellation of nationalisation.<sup>45</sup> Such cancellation would violate the sovereignty of the nationalising State.<sup>46</sup>

The arbitrator in *BP* considered the act of nationalisation an unlawful breach of contract and also as a discriminatory taking motivated by political reasons.<sup>47</sup> This, in principle, could mean that the contract had survived the act of nationalisation. However, the arbitrator, in the light of the impossibility of specific performance or restitution against a state, in effect considered the concession as terminated.<sup>48</sup> He conducted a survey of arbitral awards and also State practice and drew the line between the cases which related to the general field of interests and especially to long-term

<sup>41</sup> It has been noted by Baxter that "[T]here is, it can be asserted with some confidence, no adjudicated or arbitrated case in which restitution in kind of property has been ordered in the absence of a provision in a treaty or of municipal law which expressly or by implication calls for that action." Baxter's foreword to Lillich (ed.), *The Valuation of Property in International Law*, Vol. II.

<sup>42</sup> 62 ILR 140.

<sup>43</sup> *Ibid.* at 197.

<sup>44</sup> *Ibid.* at 198.

<sup>45</sup> Von Mehren and Kourdis are critical of the Award on this point: "... this overriding concern with enforcement is wholly inappropriate for an arbitrator, because his function is to determine the merits of the dispute in accordance with the law and not on the basis of whether an uncooperative state is going to comply with his decision." von Mehren and Kourdis, *supra*, note 34, 543-4.

<sup>46</sup> *Ibid.* at 199.

<sup>47</sup> 53 ILR 297 at 329.

<sup>48</sup> *Ibid.* at 349. The decision has been criticised on the ground that the ruling that the concession was terminated was based on the unavailability of the remedies of restitution and specific performance which may "amount to a decision that one party to a contract may put an end to that contract by his own unlawful act." Greenwood, *supra*, note 34 at 71.

contracts of a commercial or industrial undertaking and those cases concerning sovereignty over territory.<sup>49</sup> He maintained that the pronouncement of the Court in *Chorzow Factory* on *restitutio in integrum* was in relation to cases where the treaty provisions allowed for the award of such a remedy.<sup>50</sup> He noted that:

The remedy of restitution in kind thus was considered appropriate by the Court because of the coinciding circumstances that the expropriation in question violated a treaty and the main object of the treaty was to preserve a *status quo* by prohibiting the expropriation of certain property while allowing certain other such expropriations.<sup>51</sup>

He concluded that there was "no explicit support for the proposition that specific performance, and even less so for *restitutio in integrum* " were remedies of public international law "available at the option of a party suffering a wrongful breach by a co-contracting party".<sup>52</sup> The arbitrator further considered the availability of the remedy under the general principles of law. He examined different municipal laws and concluded that first there was no general principle on the question as the Anglo-American approach is quite different from that of some continental jurisdictions.<sup>53</sup> Furthermore, such principles in municipal laws, "even of those systems of laws which recognise the most far-reaching rights for an innocent party to demand specific performance, are principles of ordinary commercial law" designed to cover every-day commercial transaction with relatively short duration and not for cases similar to the present case.<sup>54</sup> And finally, the fact that one party is a State, the arbitrator stated, should not be overlooked. He agreed with the conclusions of Mitchel in his study of public contracts whereby the remedies of specific performance and restitution in kind are normally unavailable against governmental authorities under public contracts.<sup>55</sup>

In the *First Amco Asia* and *LETCO* cases, despite the fact that both tribunals found the acts of the governments concerned wrongful, they took the view that the award of

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<sup>49</sup> 53 ILR 297 at 342.

<sup>50</sup> *Ibid.*

<sup>51</sup> *Ibid.* at 339.

<sup>52</sup> *Ibid.* at 347.

<sup>53</sup> *Ibid.* at 349.

<sup>54</sup> *Ibid.*

<sup>55</sup> *Ibid.*, footnotes omitted.

the remedy was doubtful.<sup>56</sup> In *Amco*, the Tribunal was to decide on a remedy for an unlawful revocation of an investment licence by the Government of Indonesia. It considered it impossible to "substitute itself for the Indonesian Government, in order to cancel the revocation and restore the licence" as it considered it more than doubtful that this kind of remedy could be ordered against a sovereign State.<sup>57</sup> A similar conclusion was reached by the Tribunal in *LETCO* where the Tribunal considered monetary damages as the only remedy that had any chance of being complied with by the State party.<sup>58</sup> The Tribunal in *AGIP*, having found the nationalisation of an oil concession agreement containing a stabilisation clause, wrongful under international law, ordered compensation rather than restitution.<sup>59</sup>

Gray on the availability of the remedy in general maintains:

There is little, if anything, to support the primacy of *restitutio in integrum* in international arbitral practice. In any consideration of those few cases where *restitutio in integrum* was awarded it is important to distinguish between those cases where express provision for the award *restitutio in integrum* was made in the *compromis* and those where no such provision existed. The former are not numerous enough to create a general rule of international law establishing the primacy of *restitutio in integrum*, so that it is only the latter which are significant as evidence of the existence or otherwise of the suggested general rule.<sup>60</sup>

On the possibility of obtaining an order of specific performance or restitution in state contract arbitrations, El-Chiati observes that its "futility... has become so apparent that some litigants do not even bother to claim it."<sup>61</sup> The case made by the sole arbitrator Dupuy in favour of the remedy was based on the assumption that the concession was an 'internationalised contract'.<sup>62</sup> This conclusion is not shared by some other proponents of 'internationalised contract' theory. Curtis, for example, takes a similar

<sup>56</sup> *Amco Asia Corp., Pan American Development LTD. and P.T. Amco Indonesia v. Republic of Indonesia*, (1985) 24 ILM 1022 at 1038; *Liberian Eastern Timber Corporation (LETCO) v. Government of the Republic of Liberia*, (1987) 26 ILM 647 at 664-8.

<sup>57</sup> *Amco Asia*, *ibid* at para. 202.

<sup>58</sup> "... given Liberia's failure to participate in this arbitration, one must doubt whether an injunction by this Tribunal would be respected by the Government authorities. Therefore, the Tribunal concludes that only reparation in the form of money damages will be adequate in this case." (1987) 26 ILM 647 at 688

<sup>59</sup> *AGIP Company v. The People's Republic of Congo*, Award of 30 November 1979, (1982) 21 ILM 726 at 736.

<sup>60</sup> Gray, *supra*, note 1 at 13; also Higgins, R., *The Taking of Property by the State: Recent Development in International Law*, (1982) 176 RCADI 259 at 321.

<sup>61</sup> El-Chiati, *Protection of investment in the context of petroleum agreements*, (1987) 204 RCADI 9 at 161.

<sup>62</sup> 53 ILR 389 at 474.

view on the nature of concession agreements.<sup>63</sup> However, he concedes that restitution is not the proper remedy in such cases:

As to the availability of specific performance as a remedy for breach of an economic development agreement, arbitrator Dupuy's opinion appears to be in the minority. Indeed, given the increasingly frequent assertions of governments' authority over property and resources within their jurisdiction, it is difficult to believe that states would, as a general matter, accept that they should be subject to specific performance as an alternative to paying damages, even in those cases in which they had validly bound themselves to respect their agreements with foreign investors.<sup>64</sup>

It is submitted that the primacy of restitution in international law, in particular, in cases of nationalisation of concession rights of aliens is highly doubtful; the remedy has rarely been ordered in the latter. A study of national laws on the question also points to the unavailability of the remedy of restitution in cases of state contracts due to its incompatibility with the 'public interest' requirement of such contracts.<sup>65</sup>

### 5.3.2 Declaration of Rights

An international tribunal may be asked to issue a declaratory award which in effect could merely interpret the terms of the contract, and accordingly declare the rights of the parties. Therefore in the *Aramco* case the Tribunal held:

There is no objection whatsoever to parties limiting the scope of the arbitration agreement to the question of what exactly is their legal position. When the competence of the arbitrators is limited to such a statement of the law and does not allow them to impose the execution of an obligation on either of the parties, the arbitration tribunal can only give a declaratory award.<sup>66</sup>

In this case, the parties' dispute was over the interpretation of the Concession

<sup>63</sup> Curtis, C., *The legal security of economic development agreements*, (1988) 29 *Harvard International Law Journal* 316.

<sup>64</sup> *Ibid.* at 364.

<sup>65</sup> Mitchel in his comparative study of the US, UK and French contracts of public authorities arrives at the conclusion that certain remedies, namely specific performance and restitution in kind are normally unavailable against governmental authorities under public contracts. See in Mitchel, J.D.B., *The Contracts of Public Authorities*, London: Bell, London School of Economics and Political Science 1954 at 20; Bowett in his study of US law on the matter of unilateral termination concludes that the "Government has an inherent right to cancel a public contract in the public good but such a unilateral termination is a breach of contract entitling the private contractor to common law (or general) damages" Where the "Government retains a contractual right to terminate, by an express term in the contract, then termination is not a breach of contract and, though there is a duty to compensate, the duty is more restricted specifically it does not include compensation for anticipatory profits." Furthermore, "where the US Government terminates a contract under powers conferred by Statute, the statutory right to terminate impliedly becomes a term of contract" Therefore, as a consequence in a Statute-authorised termination no recovery of future profits would be allowed. See Bowett, *supra*, note 1 at 54-6.

<sup>66</sup> *Aramco Award* 27 ILR 117 at 133.

Agreement and whether **Aramco** had the "exclusive right" to transport the oil extracted from the Concession area.<sup>67</sup> The Tribunal without having been called on to decide on the question of liability rendered a declaratory award on the questions submitted to it. It held that the Concession Agreement granted **Aramco** the exclusive right to transport the oil from the Concession area to anywhere in the world<sup>68</sup> and that " Article IV of the Agreement...between the Government of Saudi Arabia and Mr.A.S. Onasis...which grants rights of priority or preference to the Saudi Arabian Tankers Company...is in conflict with the **Aramco** Concession Agreement and is not effective as against **Aramco**."<sup>69</sup>

Such an award does not have any binding force as far as its enforcement is concerned as it does not contain any decision as to any obligation for the disputing parties. However, a claimant might ask an arbitral tribunal to declare a violation of the contract by the state or the state's violation of international law. In such a case a request for a declaratory award may amount to one for *restitutio in integrum*. In cases of nationalisation, a declaratory award confirming the foreign owner's title on the nationalised property would facilitate its pursuit in domestic courts.<sup>70</sup>

In *BP*, the Company had asked for a declaration of its rights concerning the Concession Agreement and the ensuing nationalisation including:

- "1. The Libyan Nationalisation Law of 7 December 1971 and the subsequent implementation thereof were each a breach of the obligations of the Libyan Government owed to the Claimant under the Concession Agreement and so remain;
- 2.The said breaches were and are ineffective to terminate the Concession Agreement, which remain in law valid and subsisting"<sup>71</sup>

The importance of an award of the declaration of rights for *BP* was in that relying on such an award, it could claim the title to the oil extracted by anyone in its concession area after the nationalisation:

If it is found that the Claimant is entitled to be restored to the full enjoyment of its rights under the *BP* Concession, and is the owner of the oil and the assets referred to, then the claimant is entitled to an order of specific performance, alternatively, a declaratory award of entitlement to specific performance.<sup>72</sup>

<sup>67</sup> *Ibid* at 145.

<sup>68</sup> *Ibid* at 227.

<sup>69</sup> *Ibid* at 228.

<sup>70</sup> See in general Sornarajah, M., *The Pursuit of Nationalised Property*, *supra*, note 36.

<sup>71</sup> 53 ILR 297 at 323.

<sup>72</sup> *Ibid* at 330.

The arbitrator, having examined the case law on the remedy, considered the request of the Company for a declaratory award as one for specific performance or *restitutio in integrum*.<sup>73</sup> He did not separate the questions of the existence and the continuation of the Concession and that of the remedies.<sup>74</sup> The arbitrator found that specific performance and *restitutio in integrum* were not primary remedies of public international law in cases involving economic interests of the state and were therefore not applicable to this case.<sup>75</sup> It has been argued that the arbitrator in *BP* failed to distinguish between a 'mandatory order' and a 'request for declaration' recognised by many national legal systems; it is only the former which would amount to an order of specific performance.<sup>76</sup> The arbitrator considered the Libyan Nationalisation Law as a breach of the obligation of the Respondent and the Claimant was thus entitled to damages.<sup>77</sup>

In *LIAMCO* the Claimant had asked for a similar declaratory award.<sup>78</sup> The arbitrator did not render such an award arguing that it was inconsistent with the sovereignty of the state and its right to nationalise and it would be impossible to enforce.<sup>79</sup> It seems that the arbitrator in this case too considered the issues of the consequences of the Libyan act of nationalisation and remedies as one.

### 5.3.3 Compensation

A commonly accepted remedy under international law<sup>80</sup>, compensation or damages are also the most-often-awarded remedy in the arbitration of state contracts disputes.<sup>81</sup>

<sup>73</sup> *Ibid* at 353-4. The arbitrator noted: "An analysis of the cases shows ... that while declaratory awards have often been made in terms of defining the rights and obligations of parties to a concession contract, these cases have never involved the total expropriation or taking by the State of the property, rights and interests of the Concessionaire; and indeed in the most important of the cases the validity and continued existence of the contract has not been questioned." *Ibid.* at 347.

<sup>74</sup> This seems objectionable for the continuation of the Concession should not depend on whether or not certain remedies exist in international law.

<sup>75</sup> *Ibid.* at 347-348.

<sup>76</sup> Greenwood, *supra*, note 34 at 75.

<sup>77</sup> *BPAward*, 53 ILR 297 at 347.

<sup>78</sup> 62 ILR 140 at 181-2.

<sup>79</sup> *Ibid* at 200.

<sup>80</sup> Gray, *supra*, note 1 at 18.

<sup>81</sup> Toope, *supra*, note 1 at 167.

The award of damages, as opposed to a declaratory award, or an award ordering specific performance or *restitutio in integrum*, has been described as the only realistic type of award due to its potential enforceability.<sup>82</sup> An order by an arbitral tribunal to *restitutio in integrum* addressed to a state party could amount to an interference with the sovereignty of that state.<sup>83</sup> In such cases, the state party would be less likely to comply with the award. On the other hand, as noted earlier, an application for a declaratory award might not be successful as it may be viewed by the arbitral tribunal as a disguised way of seeking *restitutio in integrum*.

The term damages is usually used in the context of a contractual breach, as distinct from compensation, which often refers to a payment made to remedy the results of an interference in property rights.<sup>84</sup> Furthermore, some writers have based the distinction in the context of taking, damages are considered as an appropriate remedy for an unlawful taking and compensation for a lawful taking.<sup>85</sup> Often, arbitral tribunals have not distinguished between damages for breach of contracts and compensation for the taking of property (including contract rights). It is however important to draw such a distinction, the law applicable may be different in that the question of damages are decided by the governing law of the state contract which could be the municipal law of the state party whereas compensation for a lawful expropriation is subject to the rules of customary international law. Thus, a preliminary question arises as to the characterisation of the state's act with respect to the contract rights of aliens. Such an act can be viewed in the context of municipal and/or international law. First, if a termination by the state of its contract is treated as a normal breach of contract, and not amounting to a taking, damages will be awarded.<sup>86</sup> International law may be relevant when (i) the breach together with other elements gives rise to a denial of justice or (ii) the legislative or executive act of the state party with respect to the contract rights of the alien is regarded as an expropriation in which case, the requirements of international

<sup>82</sup> Somarajah, *supra*, note 1 at 189.

<sup>83</sup> Bowett, D., Claims Between States and Private Entities: The Twilight Zone of International Law, 5 Cath.U.L.Rev., 1986, 929.

<sup>84</sup> Gray, *supra*, note 1 at 19; Toope, *supra*, note 1 at 168.

<sup>85</sup> Bowett, Claims Between States and Private Entities, *supra*, note 81, at 938.

<sup>86</sup> Bowett, State Contracts with Aliens, *supra*, note 1 at 59.

law for expropriation will apply; the taking of contract rights will be illegal under international law if it is arbitrary and confiscatory or (iii) the act of state with regard to the rights of a private party is regarded as a breach of an internationalised contract which is considered as an international wrong giving rise to the international responsibility of the state.<sup>87</sup> Due to the reasons already considered, the viability of the last option is highly questionable.<sup>88</sup>

Major issues in the field of compensation are (i) the rule of compensation i.e. whether or not there is a duty on the State to pay compensation; (ii) the standard of compensation in which the question is whether compensation should be full or partial, and the effect of the legality of the State's action with regard to the contract on the standard of compensation; and finally, (iii) the method of valuation.

#### 5.4 Rule of compensation

There is a certain degree of disagreement on the duty of States under international law to pay compensation for an alien's expropriated property.<sup>89</sup> Many Western jurists support the view that an aspect of the international minimum standard of protection of aliens, is that the protection of aliens' property rights should include provisions for compensation in the case of taking.<sup>90</sup> International tribunals have long ruled that under international law the taking of foreign-owned property for public use should be accompanied by the payment of compensation.<sup>91</sup> This rule has been further extended by arbitral tribunals to remedy what were considered expropriatory measures directed against the contract rights of aliens.<sup>92</sup>

<sup>87</sup> Jennings, R. Y., *States Contracts in International Law*, (1961) 37 BYIL 156 at 171-3; also *Texaco*, 53 ILR 389 at 438-495.

<sup>88</sup> See ch. IV, *supra*, 4.3.3.

<sup>89</sup> For an account of different positions on the question of compensation see Sornarajah, M., *International Law on Foreign Investment*, Cambridge: Cambridge University Press 1994, Ch. 9.

<sup>90</sup> For a list of authorities on the recognition of an international rule of compensation for expropriation see Clagget, C. B., *Just Compensation in International Law: The Issues Before the Iran-US Claims Tribunal*, In *The Valuation of Nationalised Property in International Law*, Edited by R. Lillich, Vol. IV, Charlottesville: University Press of Virginia 1986, 31, note 199.

<sup>91</sup> *Norwegian Shipowners' Claims (Nor. v. US)* 1 RIAA 307, 334.

<sup>92</sup> In the *Shufeldt Claim (US v. Guat.)*, 2 RIAA 1083 at 1097 (1930) it was held that premature termination of an economic development agreement gave rise to an obligation to compensate the foreign investor. See also *Sapphire International Petroleum Ltd. v. National Iranian Oil Company (NIOC)*, Award of 15 March 1963, 35 ILR 137 at 171, *Aramco*, 27 ILR 117 at 153-4, *Aminoil*, (1982) 21 ILM 987 at 1031-4.

A contrary argument advanced by the nationalising states is that there is no longer an international obligation on states to pay compensation. The legality of the expropriation and the rules of compensation, are both matters for the municipal law of the nationalising states. The UN Resolutions of the early Seventies which call for the exclusive application of the law of nationalising states to the question of compensation are used to support the above position.<sup>93</sup> In this context, it is argued that the 1974 Charter of Economic Rights and Duties of States has disputed the duty to pay compensation.<sup>94</sup> If the law of the expropriating state is the applicable law, it may provide for such a level of compensation which could amount to no compensation at all.<sup>95</sup> It is however noted that the main conflict area in respect of compensation is not whether or not there is a duty to pay compensation but is instead concerned with the quantum of compensation.<sup>96</sup>

#### 5.4.1 Standard of Compensation

On the question of the standard of compensation, opposing views are expressed by the two sides of states contracts i.e. state parties (normally the capital-importing countries) and the foreign corporation (usually from capital-exporting countries).<sup>97</sup>

The capital exporting countries rely on the traditional formula of compensation, known as the Hull formula<sup>98</sup>, i.e. prompt, effective and adequate compensation. Their position is elaborated by Clagett as follows:

The traditional position of the United States and other capital-exporting countries has been - and remains - that international law does require the payment of compensation for expropriated alien property, and that such compensation must be "prompt, adequate and effective," or, more

<sup>93</sup> See *infra* at 203-206.

<sup>94</sup> Higgins, *supra*, note 59 at 291.

<sup>95</sup> *Ibid*

<sup>96</sup> Sornarajah, *Pursuit of Nationalised Property*, *supra*, note 34 at 188.

<sup>97</sup> There has been a great deal of literature on the subject. See Higgins, R., *The Taking of Property by the State: Recent Development in International Law*, *supra*, note 59; Clagett, B. M., *The Expropriation Issue Before the Iran-US Claims Tribunal: Is "Just Compensation" Required by International Law or Not?*, (1984) 16 *Law and Policy in International Business* 813-892; Dolzer, R., *New Foundations of the Law of Expropriation of Alien Property*, (1984) 75 *AJIL* 553; Dolzer, *Indirect Expropriation of Alien Property*, (1986) 1 *ICSID Rev-FILJ*. 41-65; Schachter, O., *Compensation for Expropriation*, (1984) 78 *AJIL*; Teson, *State Contracts and Oil Expropriations: The Aminoil-Kuwait Arbitration*, (1984) 24 *Virginia Journal of International Law* 323; Also various contributions in Lillich, R. *The Valuation of Nationalized Property in International Law*. 4 volumes Charlottesville: University Press of Virginia.

<sup>98</sup> Secretary of States Hull's letter of 21 July, 1938, reproduced in Hackworth, 3 *Digest of International Law* 655-65, 1942.

succinctly, "just." These terms mean that compensation must make the expropriated owner whole for the value he has lost. If payment is not made simultaneously with the taking, interest must be added at a realistic rate to compensate for the delay. Payment must be made in hard currency or its equivalent. And, most importantly, the measure of compensation is fair market value. Where the property taken is an ongoing business whose value is not readily ascertainable from an active market, the standard is the going-concern value, including, of course, the present value of reasonably anticipated future profits. That value is normally best determined by a well-established technique of economic analysis known as a discounted-cash-flow (DCF) study."

The theory of full compensation has the protection of acquired rights of aliens as its basis; the question of compensation is viewed from the point of view of the aliens' interest.<sup>100</sup> According to this formula, compensation is paid in full for the value of the property taken which is the 'fair market value' and in the case of an 'ongoing business' includes lost future profits. Proponents of full compensation argue that many lump sum agreements and bilateral investment treaties have endorsed the standard of just (full) compensation.<sup>101</sup> The jurisprudence of arbitral tribunals including that of the Iran-US Claims Tribunal is claimed to support the view that just compensation is a rule of customary international law.<sup>102</sup>

The developing capital-importing countries challenge the traditional formula of "prompt, adequate and effective" compensation arguing that it belonged to the time when takings normally were to serve the interests of the ruler or a ruling group in the host state. However, in the light of the new role of state with regard to economic activities, the situation has changed. Now, taking of foreign property by state is normally based on the public interest ground. The right of the state in this respect is recognised by national and international law. They further argue the incompatibility of the standard of full compensation with the right of state to restructure its economy; the application of the standard results in "the imposition of a virtual embargo on the ability of developing countries to take appropriate measures to restructure their economies."<sup>103</sup> On the effect of full compensation Professor Brownlie has observed:

It is all very well to say that nationalisation is possible- providing prompt and adequate compensation is paid. In reality this renders any major economic or social programme impossible,

<sup>99</sup> Claggett, *Just Compensation in International Law*, *supra*, note 90 at 31.

<sup>100</sup> Chowdhury, S.R., *Permanent Sovereignty and its Impact on Stabilization Clauses, Standard of Compensation and Patterns of Development Cooperation*. In *Permanent Sovereignty Over Natural Resources in International Law*, Edited by Hossean, K., London: Frances Pinter, 1984, 42 at 58-9.

<sup>101</sup> Claggett, *Just Compensation*, *supra*, note 90 at 32.

<sup>102</sup> *Ibid* at 60-71.

<sup>103</sup> Asante, S., *International Law and Foreign investment*, (1988) 37 I.C.L.Q. 586 at 600.

since few states can produce the capital value of a large proportion of their economies promptly.<sup>104</sup>

The standard of full compensation is said to have been derived from the concepts of private property peculiar to the capitalist countries of the North Atlantic and therefore could be contrary to the interest of those countries with a different notion of property.<sup>105</sup>

The concept of fair market value implicit in the "adequate" or "just" compensation is particularly inappropriate in major economic restructuring involving exclusive deprivations such as those entailed in large-scale land reform or nationalisation of strategic sectors such as natural resources. The concept is inadmissible because it purports to apply traditional commercial and property concepts in a situation which is not normal commercial purchase but more properly characterised as the intervention of State power to restructure capital and the economic system.<sup>106</sup>

With regard to the question of remedy and the level of compensation it is argued that international law makes a distinction between legal and illegal expropriations.<sup>107</sup> The compensation for a legal taking should be lower than the damages ordered for an illegal taking:

"According to the court in *Chorzow Factory*, an obligation of reparation of all damages sustained by the owner of expropriated property arises from an unlawful expropriation. The rules of international law responsibility of States apply in such a case. They provide for restitutio in integrum: restitution in kind or, if impossible, its monetary equivalent. If need be, "damages for loss sustained which would not be covered by restitution" should also be awarded. On the other hand, a lawful expropriation must give rise to the payment of fair compensation' or of "the just price of what was expropriated. Such an obligation is imposed by specific rules of the international law of expropriation."<sup>108</sup>

International law, it is maintained, now prescribes a kind of partial or 'appropriate' compensation representing an amount lower than the full market value of the expropriated property.<sup>109</sup> It is argued that a number of the UN Resolutions have changed the law in this area by recognising the right of states to decide on the question of the appropriate standard of compensation which could fall well below that of just

<sup>104</sup> Brownlie, *supra*, note 10, at 536.

<sup>105</sup> Girvan, N., *Expropriating the Expropriators: Compensation Criteria from a Third World Viewpoint*, In *The Valuation of Nationalised Property in International Law*, Vol. II, Edited by R. Lillich, Charlottesville: University Press of Virginia 1975, at 149.

<sup>106</sup> Asante, *supra*, note 103 at 600.

<sup>107</sup> Sornarajah, *International Law on Foreign Investment*, *supra*, note 89 at 364-5.

<sup>108</sup> Asante, *supra*, note 103 at 600.

<sup>109</sup> For example, the position of the respondent on the method of assessment of damages in *Amoco International Corporation v. Islamic Republic of Iran*, Award of 14 July 1987, 15 Iran-US CTR 189 at 254-5.

compensation in the sense of the full market value of the property taken.<sup>110</sup> Proponents of 'appropriate' compensation approach the question of compensation from the point of view of the nationalising state:

The doctrine which constitute the legal foundation of the conduct actually followed by States is the principle of unjust enrichment. If nationalising State were to grant no compensation when nationalising alien property, it would enrich itself without justification at the expense of a foreign State considered as a distinct political, economic and social unit. Through the exercise of its sovereign right to nationalise, that State would be depriving an alien community of the wealth represented by the investments it has made on foreign soil: it would be taking undue advantage of the fact that economic resources originating in another State had penetrated its territorial domain.

The principle signifies that it is not the loss or impoverishment of the expropriated individual owner, in all its elements, which must be taken into account, but the enrichment, the beneficial gain which has been obtained by the nationalising State. The measures which bring about a transfer of wealth in favour of the nationalising State or one of its agencies are those which give rise to a duty to compensate. Measures as the total suppression, for reasons of general policy, of a detrimental or inconvenient industrial or commercial activity, are not subject of compensation. The reason is that in those cases no enrichment is gained by the nationalising state, even if a loss has been experienced by the foreign owner. Similarly, goodwill will not be a ground for compensation when, the abolition of free market conditions of competition nullifies the value of this intangible asset.

However, the municipal law principle of unjust enrichment, in all its aspects cannot be mechanically transplanted to the sphere of international law. Lord McNair wisely advised that international law does not import private law rules and institutions 'lock, stock and barrel' but regards them 'as an indication of policy and principles'. What makes the principle of unjust enrichment highly relevant in the field of nationalisation is its *equitable foundation*, which makes it necessary to take into account all the circumstances of each specific situation and to balance the claims of the dispossessed alien with the undue advantages that he may have enjoyed prior to nationalisation (italics supplied).<sup>111</sup>

It is further contended that the Hull formula as the position of the US Government concerning the standard of compensation has been qualified. The elimination of 'prompt, adequate and effective' from the Third Restatement of the Foreign Relations Law of the United States allows for a lower standard of compensation.<sup>112</sup> Further references are made to the treatment of the nationalisation of nationals' property by states where the standard of compensation was held to be lower than the full value of

<sup>110</sup> See, *infra*, the discussion of UN Resolutions.

<sup>111</sup> de Arechaga, *supra*, note 23 at 299-300

<sup>112</sup> Schachter, *supra*, note 97 at 122; for a contrary opinion see Gann, P. B., Compensation Standard for Expropriation, (1984-85) 23 Col.J.T.L. 615.

property taken.<sup>113</sup>

In addition to the above, it is argued that there may be various circumstances which warrant a standard of partial compensation such as “cases in which fundamental changes in the political system and economic structure of the State or far-reaching social reforms entail interference, on a large scale, with private property.”<sup>114</sup>

#### 5.4.1.1 Possible Sources of Standard of Compensation

##### (i) *Bilateral Investment Treaties* <sup>115</sup>

An argument for the payment of “just”, “adequate” or “full” compensation is further supported by the fact that many bilateral treaties make reference to such a standard of compensation as that of international law.<sup>116</sup> Such provisions are said to be evidence of the rule of customary international law on compensation.<sup>117</sup>

The main objective of these treaties is to provide protection for the investments made by the nationals of the two state parties in each others’ state.<sup>118</sup> There has been an increase in the number of such treaties. Although, theoretically these treaties are to be equally beneficial to both parties, they mainly serve the interest of the investor country, often a developed country, and through that the interest of multinational which are the actual investors. The basis of the developing country’s entry into such treaties almost invariably is to attract the flow of foreign investment into its territory. It is a matter of

<sup>113</sup> *Lithgow and Others*, was a case before the European Court of Human Rights, the dispute related to the property interests of a group of British nationals which had been nationalised under the Aircraft and Shipbuilding Industries Act, 1977. The applicants alleged that the compensation they were to receive from the Government was “grossly inadequate and discriminatory” and therefore in violation of Art.1 of Protocol No.1 to the European Convention on Human Rights, stating that “[e]very natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.” The Court held that : “Art.1 does not ... guarantee a right to full compensation in all circumstances, since legitimate objectives of ‘public interest’, such as pursued in measures of economic reforms or measures designed to achieve greater social justice, may call for less than reimbursement of the full market value.” Judgment of July 8, 1986, European Court of Human Rights

<sup>114</sup> Schachter, O., *Compensation for Expropriation*, *supra*, note 97 at 123, quoting H. Lauterpacht (footnote omitted).

<sup>115</sup> In general See Sornarajah, M., *International Law on Foreign Investment*, *supra*, note 89; Salacuse, J.W., *BIT by BIT: The Growth of Investment Treaties and Their Impact on Foreign Investment in Developing Countries*, (1990) 24 *Int. Lawyer* 655; Pogany, I., *Bilateral Investment Treaties*, (1992) 7 *ICSID Rev.-FILJ* 1; for a bibliography on the subject see (1992) 7 *ICSID Rev.-FILJ* 231.

<sup>116</sup> Clagett, *Just Compensation in International Law*, *supra*, note 90 at 71-73.

<sup>117</sup> *Ibid* at 76-77.

<sup>118</sup> Sornarajah, *supra*, note 89 at 226.

controversy whether bilateral investment treaties can create customary international law as they lack uniformity.<sup>119</sup> Furthermore, it has been maintained that "there is little evidence beyond the special bundle of benefits and imposition in the circumstances of a purely bilateral relationship. Many of these states [developing states] have declared in international forums that the obligations they have assumed under bilateral arrangements do not represent their views on general international law, and have accordingly adopted a different posture on the same issues in the context of multilateral negotiations towards the promulgation of general international legal standards."<sup>120</sup> The Tribunal in *AAPL* took the view that bilateral investment treaties create *lex specialis* as between the parties rather than creating customary international law.<sup>121</sup> Therefore, given the existence of the conflict between developing countries advocating the primacy of the law of nationalising state on the question of the standard of compensation and capital exporting countries favouring an 'an international law standard of full compensation', bilateral investment treaties seem to offer *ad hoc* solutions to the problem.

(ii) *Lump sum and other Claims Settlement Agreements*

A lump sum agreement has been defined as "an agreement arrived at by diplomatic negotiations between governments to settle outstanding claims by the payment of a given sum without resorting to international adjudication. Such a settlement permits the state receiving the lump sum to distribute the fund thus acquired among claimants who may be entitled thereto pursuant to domestic procedure."<sup>122</sup> The task of the distribution of a lump sum is normally with a national claims commission which is set up by the claimant state.<sup>123</sup> One significant factor undermining such agreements as evidence of state practice is that only a few lump sum agreements have involved the assignment or

<sup>119</sup> *Ibid.*

<sup>120</sup> Asante, *supra*, note 103 at 602; also Chowdhury, in *Permanent Sovereignty Over Natural Resources in International Law*, *supra*, note 100 at xvii; Dlozer, *supra*, note 97 at 576.

<sup>121</sup> *Asian Agricultural Products Limited v. The Republic of Sri Lanka*, Award of June 27, 1990 produced in (1991) 6 ICSID Rev.-FILJ 526.

<sup>122</sup> Gray, *supra*, note 1 at 178 quoting E.D. Re (1964) ASIL 39; See in general, Lillich, R. and Weston, *International Claims: Their Settlement by Lump Sum Agreements*, 1975.

<sup>123</sup> For the study of national claims commissions see Lillich, R., *International Claims: Their Adjudication by National Commissions*, Syracuse: Syracuse University Press 1972.

admission of liability under international law.<sup>124</sup> The study of lump-sum settlement agreements relating to nationalisations indicate that the compensation agreed upon generally was less than the amount of the original claim of the alien which represented the full value of the nationalised property.<sup>125</sup> The role of non-judicial elements and often the existence of an element of compromise in lump sum and claims settlement agreements makes it difficult to come to a conclusion as to their contribution to a rule of international law on the standard of compensation. The tribunal in *Amoco International Finance* stated:

As a rule, state practice as reflected in settlement agreements cannot be considered as giving birth to customary rules of international law, unless it presents specific features which demonstrate the conviction of the state parties that they were acting in application of what they considered to be settled law. The provisions of such an agreement, indeed, are the outcome of negotiations in which many motivations other than legal ones may have prevailed.<sup>126</sup>

Bowett states that "if all states practice has to be isolated from factors other than that 'elements of law', there would be little evidence of State practice- in this or any other field-which could be used as an evidence of custom."<sup>127</sup> More specifically, the hidden and covert benefits given to the alien not reflected in the agreement would make it difficult to determine the exact amount of compensation.<sup>128</sup>

### (iii) UN Resolutions

A series of the United Nations General Assembly resolutions have made references to the question of compensation for the expropriation of aliens' property and the rules applicable to its standard. The first major instrument in the series was adopted in 1962 Resolution 1803 (XVII) on Permanent Sovereignty over Natural Resources provides for the payment of 'appropriate' compensation which is determined according to the national law of the expropriating state and international law.<sup>129</sup>

<sup>124</sup> Gray, *supra*, note 1 at 179-80.

<sup>125</sup> Amerasinghe, C. F., The Quantum of Compensation for Nationalised Property, In 3 *The Valuation of Nationalized Property in International Law*, Edited by R. Lillich. Charlottesville: University Press of Virginia 1975, 91 at 115.

<sup>126</sup> (1987) 15 Iran-US CTR 189.

<sup>127</sup> Bowett, State Contracts with Aliens, *supra*, note 1 at 66.

<sup>128</sup> Amerasinghe, *supra*, note 125 at 116; Also see Bowett, *supra*, note 1 at 61 and authorities cited therein.

<sup>129</sup> Para.4. For the text of the Resolution see 17 UN GAOR Supp. (No. 17) at 15, UN. Doc. A/5217 (1962), reprinted in (1963) 2 ILM 233.

Under Resolution 3171(XXVIII), passed by the General Assembly in 1973, the duty of expropriating states to pay compensation is challenged. Furthermore, it provides for the exclusive application of the law of the nationalising state to the question of compensation. Para. 3 of the resolution provides "that each State was entitled to determine the amount of *possible* compensation and the mode of payment, and that any disputes which might arise should be settled in accordance with the national legislation of each State carrying out such measures..."<sup>130</sup>

According to Art. 2.2(c) of Resolution 3281 (XXIX), known as the Charter of Economic Rights and Duties of States 1974, every State has the right "to nationalise, expropriate or transfer ownership of foreign property, in which case *appropriate* compensation should be paid... In any case where the question of compensation gives rise to a controversy, it shall be settled under the *domestic law of the nationalising state and by its tribunals..(italic supplied)*"<sup>131</sup> Therefore, while affirming the duty of states to pay compensation, the question of the measure of compensation is left entirely to the law of the nationalising state. However, despite the reference to the national law of the nationalising state as applicable to the question of compensation, the preamble of this resolution also refers to Resolution 1803 (XVII) which makes reference to the requirement of 'appropriate' compensation according to international law. Therefore, it can be argued that the standard of 'appropriate' compensation according to international law provided by Resolution 1803 has not been superseded by Para.3 of Resolution 3171(XXVIII). This view is supported also by the pattern of voting which points to the fact that Resolution 1803 was adopted by a wider interest groups than Resolution 3171(XXVIII).<sup>132</sup> Furthermore, it has been noted that some of the states which voted for Resolution 3171 in practice still follow the position set out in Resolution 1803 (XVII).<sup>133</sup> Relying on the above it has been suggested that the Resolution 1803 (XVII) evidences the rule of customary international law regarding

<sup>130</sup> 28 UN GAOR Supp. (No.30) at 52, UN Doc. A/9030 (1973), reprinted in (1974) 13 ILM 238.

<sup>131</sup> G.A.Res. 3281(XXIX),art. 2(2)(c). 29 UN GAOR Supp. (No.31) at 50. UN Doc. A/9631 (1974), reprinted in (1975) 14 ILM 251.

<sup>132</sup> Resolution 1803 was voted for by both developed and developing countries whereas some of the major capital-exporting countries did not vote for Resolution 3171.

<sup>133</sup> See Amerasinghe, C. F., Issues of Compensation for the Taking of Alien Property in the Light of Recent Cases and Practice , (1992) 41 I.C.L.Q. at 32-36.

compensation which requires the payment of 'appropriate' compensation.<sup>134</sup>

On the binding effect of these resolutions in general and that of Art.2.2(c) of the Charter in particular, opinion is divided, in the extreme, between those who deny resolutions any legal significance and those which consider them as evidence of rules of customary international law.<sup>135</sup> The middle ground position seems to be advanced by Shaw that although, in principle, the General Assembly resolutions are recommendatory "in terms of the generation of state practice... [they] may ... lead to binding custom."<sup>136</sup> However, he reminds us of "the dangers in ascribing legal values to everything that emanates from the Assembly Resolutions" in the light of the influence of political compromises on such resolutions.<sup>137</sup> This is somewhat similar to the view taken by the arbitral tribunal in *Framatome* which stated:

The general Assembly of the UN can only, in principle, issue "recommendations" which are not of a binding character, according to Art.10 of the Charter of the United Nations... However, a legal validity may today be recognised in relation to certain of the UN Resolutions in well-defined conditions, in other words, essentially to the extent that these Resolutions are accepted by the majority of the Organisation.<sup>138</sup>

<sup>134</sup> See *Texaco Award* 53 ILR at 485-95; *Aminoil*, 21 ILM at 1021-22;

<sup>135</sup> According to some jurists, the resolutions are nothing but political declarations with no legal force. See, for example, Franck, *General Course on Public International Law*, *supra*, note 21 at 468-9; also discussion of resolutions in *Texaco* below. Others have treated them as a source of contemporary international law. de Aréchaga, *International Law in the Past Third of the Century*, *supra*, note 23 at 300-304. In particular, on the binding effect of Art.2.2(c) of the Charter, it has been argued that it does not express the established rules of international law but reflects a desired goal to be achieved in the realisation of a new international economic order. See Amerasinghe, *Issues of Compensation*, *supra*, note 133 at 35 and the cited authorities. Chowdhury maintains that the principles embodied in the Charter have the character of legal norms, albeit some of them may be characterised as 'emerging norms' simply by the fact that the resolutions of the General Assembly are not binding. Chowdhury, *supra*, note 93, at 6. Brownlie considers the resolutions as evidence of the formation of rules of customary (or general) international law. Brownlie, I., *Legal Status of Natural Resources in International Law*, (1980) 162 RCADI 854. Professor Dupuy in *Texaco* drew a distinction between resolution 1803 which was voted for by 87 (including several Western developed countries) to 2, with 12 abstentions on the one hand, and on the other hand other resolutions which faced strong opposition from Western countries. 53 ILR 389 at 483-495. For the resolutions to be legally binding, he maintained, they must be accepted by the Members of the United Nations (491). Therefore, there does not arise a consensus as to a new rule of customary international law on compensation as the resolutions do not evidence *opinio juris* or state practice. At best, the resolutions could be considered as proposals for action, *de lege ferenda* and being so they could not be applied as law. *Ibid.* at 493. Higgins from another premise, reaches the same conclusion as Dupuy's: "... in a sense it is not the binding quality of the individual resolutions that is at issue. For it can be ... that resolutions which are at times non-binding can, if they affirm principles of international law which overwhelming numbers of States adhere to *opinio juris*, evidence developing customary international law. With this somewhat different analysis, I nonetheless reach a similar conclusion to that given in the *Texaco-Libya* case. I do so because the State practice does not evidence - not even among those who voted for resolution 3201(S-VI) and for the New International Economic Order resolution - adherence to the principles proclaimed in these later resolutions." Higgins, *supra*, note 50 at 293.

<sup>136</sup> Shaw, M. N., *International Law*, 3rd edition, Cambridge:Grotius 1991, 95.

<sup>137</sup> *Ibid.*

<sup>138</sup> VIII YBCA 94 at 115.

From the above it would appear that the UN resolutions do not offer themselves as clear legal authority on the question of the standard of compensation.

#### (iv) *Arbitral Awards*

The question of the standard of compensation has been dealt with in many arbitral awards. In *LIAMCO* the sole arbitrator decided the case according to the general principles of law and considered it was *reasonable and just* to order *equitable compensation*.<sup>139</sup> In *Aminoil* the Tribunal took the view that a lawful nationalisation must be accompanied by “*appropriate*” compensation. Such compensation is determined taking into account “all the circumstances relevant to the particular concrete case.”<sup>140</sup> Among these are the nationalising state’s attitude towards foreign investment, the value of the assets and the legitimate expectations of the investor.<sup>141</sup>

The Iran-US Claims Tribunal has in many cases endorsed the standard of full compensation. The Tribunal’s application of this standard has been based on international law and the Treaty of Amity between Iran and the United States.<sup>142</sup> *The American International Group*, a dispute relating to the nationalisation of the insurance industry, was one of the first cases to deal with the question of standard of compensation. The Claimant had sought compensation for the market value of its share interest in the insurance company. The Tribunal noted:

“It is a general principle of public international law that even in the case of lawful nationalisation the former owner of the nationalised property is normally entitled to compensation for the value of property taken”<sup>143</sup>

The Tribunal ruled that the nationalisation of the Claimant’s shares in Iran-America, the entity in question, entitled the Claimant to compensation on the basis of the fair market value of its shares at the date of nationalisation.<sup>144</sup> A similar conclusion was reached by the Tribunal in *Tippetts* which considered that the standard of the full

<sup>139</sup> 62 ILR 140 at 210.

<sup>140</sup> *Aminoil*, (1982) 21 ILM 976 at 1033.

<sup>141</sup> *Ibid* at 1033-34.

<sup>142</sup> Treaty of Amity, Economic Relations and consular Rights, Aug. 15, 1955, United States-Iran, 284 U.S.T.S 93.

<sup>143</sup> *American International Group v. Islamic Republic of Iran*, (1983) 4 Iran-US CTR 96 at 105.

<sup>144</sup> *Ibid.* at 106.

compensation was applicable.<sup>145</sup> The Tribunal has made it clear that it did not matter whether the applicable standard was that of the Treaty of Amity or of customary international law as both would point to the full standard of compensation.<sup>146</sup> The Tribunal, however, in *INA* stated as *obiter* that “[I]n the event of large scale nationalisations of a lawful character, international law has undergone a gradual reappraisal, the effect of which may be to undermine the doctrinal value of any “full” or “adequate” (when used as identical to “full”) compensation standard as proposed in this case.”<sup>147</sup> Judge Lagergren in his separate opinion in this case emphasised that in such cases, i.e. lawful large scale nationalisations, the “fair market value” standard should be “discounted in taking account of “all circumstances.”<sup>148</sup>

The significance of the Tribunal’s case law on the question of remedies, in general, and that of the method of damage assessment in particular, is somewhat undermined by the ambiguity of its approach to the question of the applicable law and the involvement of an element of compromise in its pronouncements on these matters.<sup>149</sup>

A number of ICSID awards have also addressed the question of the standard of compensation. In *AGIP*, the Tribunal endorsed the full standard of compensation *subject to some limitations in certain circumstances* which were not present in this case.<sup>150</sup> In *LETCO* the concession agreement had specifically provided for remedies for breach:

Unless otherwise specifically provided and notwithstanding the Government’s right of revocation under Section 4 of this Article, the penalty for any breach of Agreement or, if agreement cannot be reached, then damages or specific performance as fixed by the arbitral tribunal.<sup>151</sup>

The Claimant, due to the impracticality involved, did not seek specific performance.<sup>152</sup> The Tribunal, applying the Liberian law as the applicable law decided

<sup>145</sup> *Tippetts, Abbot, McCarthy, Stratton v. TAMS-AFFA*, 6 Iran-US CTR 219.

<sup>146</sup> *INA Corporation v. Islamic Republic of Iran*, 8 Iran-US CTR 373 at 378 where the Tribunal emphasised that, on the subject of nationalisation, the Treaty of Amity, as *lex specialis*, was similar to customary international law, the *lex generalis*.

<sup>147</sup> *Ibid.* (footnote omitted).

<sup>148</sup> *Ibid.* at 390.

<sup>149</sup> Gray, *supra*, note 1 at 182-3 and cited authorities therein; also Amerasinghe, C.F., *Issues of Compensation*, *supra*, note 133 at 43-45.

<sup>150</sup> *AGIP Co. Spa. v. Government of the Popular Republic of Congo*, 67 ILR 318 at 341.

<sup>151</sup> Art. VII of the Concession Agreement: “Penalty for Breach of Agreement”, *Liberian Eastern Timber Corporation v. Republic of Liberia*, (1987) 26 ILM 647 at 668.

<sup>152</sup> *Ibid.*

on the question of compensation and held that: "... both according to international law and, more importantly, Liberian law, LETCO is entitled to compensation for damages for both its lost investments and its forgone future profits."<sup>153</sup>

In *Asian Agricultural Products Limited (AAPL) v. Sri Lanka*, the Claimant sought remedies for the recovery of its investment which had been destroyed as a result of a military operation.<sup>154</sup> The Tribunal in this case also applied the full standard of compensation.<sup>155</sup>

In *SPP v. Egypt*, an ICSID tribunal considered the cancellation by the state of an agreement concerning a tourist development project as "a lawful exercise of the right of eminent domain" under international law which entitled the Claimant, as a party whose legitimate rights were affected to indemnity in the form of "fair compensation".<sup>156</sup>

A brief review of arbitral awards points to the desire of arbitral tribunals to arrive at a reasonable and fair level of compensation taking into account all different circumstances relevant to the case.<sup>157</sup>

Having studied the above possible sources of a standard of compensation, it would appear that there is no consensus as to the viability of these sources; neither is there

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<sup>153</sup> *Ibid.* at 670.

<sup>154</sup> Award and Dissenting Opinion of June 27, 1990 produced in (1991) 6 ICSID Rev.-FILJ 526; for a commentary of the award see Perre, A. R., *Asian Agricultural Products LTD. v. The Republic of Sri Lanka*, (1991) 2 American Review of International Arbitration 216.

<sup>155</sup> *Ibid.* at para. 87: "Both Parties are equally in agreement about the principle, according to which, in case of property destruction, the amount of the compensation due has to be calculated in a manner that adequately reflects the full value of the investment lost as a result of said destruction and the damages incurred as a result thereof."

<sup>156</sup> *Southern Pacific Properties (Middle East) Limited v. Arab Republic of Egypt*, Award of 1992, reprinted in (1993) ICSID Rev.-FILJ 328 at 373.

<sup>157</sup> This approach of arbitral tribunals is not always welcomed, in particular, by the adherent to the old formula of "full" compensation. For example, Aldrich questioning the legality of awards of the Tribunal in *Foremost and Kodak*, which ordered less than full compensation, maintains: "Certainly, it was my impression that Judge Lagergren and Virally, the chairmen of chambers for *Foremost* and *Kodak* respectively, generally sought what they considered to be the *equitable results* and were not always comfortable with the full compensation standard that the 1955 Treaty of Amity made Applicable to all taking of property rights. (italics supplied)." Aldrich, H.A., *What Constitute a Compensable Taking of Property? The Decisions of the Iran-United States Claims Tribunal*, (1994) 88 AJIL 585 at 591.

any consensus as to the standard of compensation emerging therefrom.<sup>158</sup> The source of the conflicting views on the standard of compensation largely relates to the "differing interests of the philosophies and the feeling of the developing States that the law in this area reflects the structural inequalities in the international setting of the North-South relations."<sup>159</sup> Therefore, the question of compensation should be looked at in its wider economic and political setting where there is a struggle between those who advocate a change in current economic order and those who are in favour of maintaining the existing economic order.<sup>160</sup> A trend, however, is noted in favour of the standard of "appropriate" compensation in the sense of a measure lower than full compensation.<sup>161</sup>

#### 5.4.2 Valuation Methods and Compensation

Apart from the discussion as to the meaning given to the terms 'just', 'adequate', 'fair' or 'appropriate' compensation, which basically reflects the controversy as to whether full or partial compensation should be paid, there is also the question of the heads of claims or what is to be compensated. This is addressed here in the context of the study of the principles applicable to the valuation of the property taken, including contract rights.<sup>162</sup> Such principles are particularly important when full compensation

<sup>158</sup> A recent study a number of multilateral documents on the standard of compensation concludes that : "[W]hile the requirement to pay compensation in case of expropriation is in principle recognised in almost all documents, great divergences exist as to the amount, the mode of payment and period of time for payment of compensation, i.e. as to what represents *adequate* compensation. The differences are so extreme that it is in fact impossible to reconcile the various standards of compensation in one formula... In should be noted that the often invoked compensation formula "prompt, adequate and effective" which originated in Hull letter is contained in *only one* of the multilateral documents reviewed (italics supplied)." Tschofen, F., *Multilateral Approaches to the Treatment of Foreign Investment*, In *Legal Treatment of Foreign Investment: The World Bank Guidelines*, Edited by E. Shihata, Dordrecht/London: Nijhoff 1993, 267 at 293.

<sup>159</sup> Sornarajah, *Pursuit of Nationalised Property*, *supra*, note 36 at 189.

<sup>160</sup> *Ibid.*

<sup>161</sup> From the study of state practice and arbitral awards, Higgins concludes that the application of a standard of prompt, effective and adequate compensation has most often resulted in partial compensation. Higgins, *supra*, note 50 at 294.

<sup>162</sup> Westberg and Marchais maintain that "[T]o focus exclusively on the "standard" of compensation, however, would be very misleading. This is because determination of the applicable "standard" does not by itself determine the actual amount of compensation to be paid by States that expropriate the interests of foreign investors. The "method of valuation" to be used in meeting the applicable "standard" must also be determined, and the methods selected in most cases have resulted in the award of amounts very substantially below the amounts claimed." Westberg, J. A. and B. Marchais, *General Principles Governing Foreign Investment as Articulated in Recent International Tribunal Awards and Writings of Publicists*, In *Legal Treatment of Foreign Investment: "the World Bank Guidelines*, Edited by E. Shihata, Dordrecht/London: Nijhoff 1993, 337 at 344.

has been awarded as such standard could include lost future profits, quantification of which could be highly speculative depending on the particular method of valuation selected and its application. On the definition of valuation as distinct from compensation, Lauterpacht states:

"Valuation describes the process of determining the economic worth of an object ... Valuation is an objective process carried out by reference to certain accountancy techniques. No doubt it may involve the exercise of discretion by a valuer- but the elements of discretion are always strictly related to the character of the item being valued. The determination of compensation, on the other hand, can in theory be influenced by any number of external factors, such as the amount available to pay compensation, the respective positions of the owner and the expropriator, or the extent to which the owner has hitherto benefited from the property in question. There is no absolute requirement that value and compensation should be equal. Their relationship will depend entirely upon the applicable legal rule- for example, that in the particular case, the owner shall receive compensation amounting to only 10% of the value or, in another situation, that the owner shall receive full value."<sup>163</sup>

A logical relationship is noted between the method of valuation and the theory of compensation in that, if the underlying rationale of the compensation for a nationalised property is the protection of an acquired right such methods of valuation should be employed which "result in placing the owner of the nationalised property in the position he would have been if he had been allowed to continue in business, insofar as money can do so... This warrants the payment of market value, which normally means the price a willing buyer would pay a willing seller in a viable market."<sup>164</sup> On the other hand, if the underlying theory of compensation is "unjust enrichment" the valuation method should reflect the value of the nationalised property to the nationalising state.<sup>165</sup> The main issue and difference will be on the availability of an award of lost future profits as part of the compensation. Assessment of damages on the basis of unjust enrichment is based on the net book value of the property taken and does not allow for the inclusion of lost future profits.<sup>166</sup> Often, state parties contend that this method

<sup>163</sup> Lauterpacht, E., *Aspects of the Administration of International Justice*, Cambridge: Grotius Publication 1991 at 130.

<sup>164</sup> Amerasinghe, *The Quantum of Compensation for Nationalised Property*, *supra*, note 125 at 94-5.

<sup>165</sup> *Ibid.* at 96.

<sup>166</sup> Net book value is "[T]he value on the books of account of the owner's equity in an enterprise, which is the amount that remains after deducting the total liabilities from the total assets of an enterprise (company) in the amounts that these items appear on the company's books of account. There may be some variation depending on accounting principles employed for keeping the books." Amerasingh, *supra*, note 133 at note 51.

should be used for valuation purposes.<sup>167</sup> The Discounted Cash Flow (DCF), however, allows for the full recovery of lost future profits corresponding to the expectation interest of the claimant.<sup>168</sup>

The question, in municipal and comparative law contexts, has been dealt with from the view point of the protection of the underlying interest of the claimant, as a basis for the measure of damages for a breach of contract.<sup>169</sup> In principle, it seems that the "object of damages is to put the aggrieved party into as good a position as that in which he would have been if the contract had been performed, damages should be assessed on the basis of the expectation interest in all cases."<sup>170</sup> It is, however, noted that "no system of law accepts this argument, both reliance and restitution being recognised as alternative and sometimes as cumulative bases of recovery."<sup>171</sup> The protection of reliance interest is the objective of the remedy when it aims to put the aggrieved party into the position which he would have been in if the contract had never been made.<sup>172</sup> Finally, the protection of the restitution interest is the object of the

<sup>167</sup> *Lena Goldfields (The Arbitration Between the Lena Goldfields Ltd. and the Soviet Government)*, (1950) 36 Cornell L.Q. 31-36) is the main case where compensation for deprivation of concession rights was decided on the basis of unjust enrichment other than on the principles of contractual damage assessment. It was however noted by the Tribunal in *Amoco* that while unjust enrichment is a good starting point to avoid any enrichment or deprivation, however the going concern value should be taken as a basis for the valuation. *Amoco International Finance Award*, 15 Iran-US CTR 189 at 257.

<sup>168</sup> Various methods of valuation may be employed by arbitral tribunals to arrive at the fair market value. In the context of valuation of an expropriated ongoing business for the purposes of determining the amount of compensation, capital-exporting countries have pressed for the employment of (DCF) method. Clagett, B. M., *Just Compensation in International Law*, *supra*, note 90 at 31-97. What is referred to as discounted cash flow "briefly involves the following steps:

(a) making a forecast of the income and cash flow of the enterprise into the future for a given number of years and then calculating for each year the present value of the cash flow by using a discount factor or figure, which takes into account the perceived risks;

(b) adding up the values of all the assets of the enterprise which are expected to be present at the end of the projected period (the residual assets) and calculating the present value of the figure;

(c) adding up the present values of the cash flows for each year (see (a) above) and the present value of the assets expected to remain at the end of the whole period (see (b) above) and then deducting any debts or other liabilities expected to remain at the end of the period." Amerasingh, *supra*, note 133 at note 51; also Khalilian, S. K., *The place of discounted cash flow in international commercial arbitrations: Awards by Iran-US Claims Tribunal*, (1991) 8 (1) *Journal of International Arbitration* 31, at 32.

<sup>169</sup> On this point some recent works have referred to Fuller, L. L. and Perdue Jr., *The Reliance Interest in Contract Damages*, (1936-37) 46 *Yale Law Journal*, also Treitel, *Remedies for Breach of Contract*, *supra*, note 14; Ogus, *The Law of Damages*, London: Butterworth 1973 at 235. In the specific context of state contract arbitration the question has been addressed by Paasivirta, *Participation of States in International Contracts*, *supra*, note 1 at 249-261; Toope, *Mixed International Arbitrations*, *supra*, note 1 at 173.

<sup>170</sup> Treitel, *ibid* at 88.

<sup>171</sup> Ogus, *supra*, note 169 at 290.

<sup>172</sup> Treitel, *supra*, note 15 at 83.

remedy when the aggrieved party seeks to recover the benefit conferred by him on the defaulting party.<sup>173</sup>

There could be various grounds, for a court to decide to apply a number of doctrines with the result of limiting the amount of compensation:

**There are rules: to construe the advantage promised as narrowly as possible, to exclude uncertain, remote and non-pecuniary advantage, and in some special cases for the purposes of public policy to exclude compensation for the expectation interest altogether. Most important of all, there is the doctrine of mitigation which forbids the recovery of compensation for those losses which the plaintiff might reasonably have avoided.**<sup>174</sup>

Ogus compares the object of compensation in tort, that is the restoration of the *status quo ante*, with that in contract, which in Western legal systems, in principle, is the protection of expectation interest, and observes that the reason for the difference is the "foundation of the law of contract" in the economic philosophy of Western capitalist societies which is geared to stimulating economic activity, facilitating reliance on business agreements and protecting the 'credit system'.<sup>175</sup> He concludes that "in societies which do not share the same economic philosophies it is by no means obvious that recovery of lost anticipated profits is always to be tolerated."<sup>176</sup>

The protection of expectation interest as the object of compensation requires the award of lost future profits. However, as noted above, in municipal law, the award of lost future profits would not be possible when the expectation interest is uncertain.<sup>177</sup> From this premise, it has been argued that the "uncertain international political situation" would render "international profits" often speculative.<sup>178</sup> Therefore, substitution of protection of reliance or restitution interest as a starting point for measure of damages is proposed.<sup>179</sup> Such a substitution would reduce the ultimate amount arrived at by a tribunal especially with regard to lost future profits. There may be instances that, based on the recognition of the public interest of the state party, arbitral tribunals may use their discretion to modify the amount of damages on the

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<sup>173</sup> *Ibid.*

<sup>174</sup> Ogus, *supra*, note 169 at 290-291.

<sup>175</sup> *Ibid* at 285.

<sup>176</sup> *Ibid.*

<sup>177</sup> See Treitel, *supra*, note 15 at 97.

<sup>178</sup> Toope, *supra*, note 1 at 179.

<sup>179</sup> *Ibid.*

basis of expectation interest. These include: "a state's capacity to pay, large scale nationalisations, natural resources and 'mitigation of damages'."<sup>180</sup>

A study of state contract arbitral awards indicates that tribunals have not adhered consistently to one method of valuation. Often, they decided on a particular method with regard to the *circumstances* of the case. Furthermore, they have involved subjective elements in valuation which is by definition an objective process. In *LIAMCO*, the Claimant had presented to the Tribunal a DCF valuation. The sole arbitrator dealt with the question of compensation on the basis of the general principles of law and held that "taking equity into consideration, it would be reasonable and just to adopt the formula of "equitable compensation" as a measure for the estimation of damages."<sup>181</sup> Such a measure would allow for lost future profits.<sup>182</sup> The Tribunal rejected both net-book value and DCF valuations as two different exaggerated extremes.<sup>183</sup>

The Tribunal in *Aminoil* did not use the projection of the company's future profits as the basis for a calculation of the "appropriate" compensation since it was considered by the Tribunal that the parties had "adopted a different conception in the course of their relations and negotiations- namely that of the reasonable rate of return."<sup>184</sup>

In *Benvenuti*, the Tribunal rejected the Claimant's request for an award based on the DCF method as it considered the expropriated property as not having become a going concern and therefore awarded the amount originally invested.<sup>185</sup>

In *AAPL*, the Tribunal did not agree with the Claimant's request for the application of the DCF method, which would allow for the inclusion of lost future profits, on the ground that "neither the "good will" nor the "future profitability" of Serendib could be reasonably established with a sufficient degree of *certainty*."<sup>186</sup> The Tribunal in *LETCO* relying partly on the DCF valuation presented by the Claimant, as noted

<sup>180</sup> See in detail in Paasivirta, *supra*, note 1, 262-271 and cases discussed therein.

<sup>181</sup> (1981) 20 ILM 1at 76.

<sup>182</sup> *Ibid.*

<sup>183</sup> *Ibid.* at 81.

<sup>184</sup> *Aminoil Award*, (1982) 21 ILM 976 at 1035.

<sup>185</sup> *Benvenuti & Bonfant v. The People's Republic of Congo*, Award of 15 August 1980, (1982) 21 ILM 740.

<sup>186</sup> *AAPL Award*, (1992) XVII YBCA 106 at 139-140.

earlier, allowed for the compensation of damages for both its lost investment and its forgone future profits.”<sup>187</sup> The Tribunal in *First Amco Asia* used the DCF method to determine the value of the Claimant’s lost management rights. It was stated by the tribunal:

Now, while there are several methods of valuation of going concerns, the most appropriate one in the present case is to establish the net present value of the business, based on a reasonable projection of the foreseeable net cash flow during the period to be considered, said net cash flow being then discounted in order to take into account the assessment of the damages at the date of the prejudice.<sup>188</sup>

The ICSID Tribunal in *SPP v. Egypt*, in its valuation of the contract rights of the Claimant, having decided on the ‘fair’ measure of compensation, rejected the DCF method of valuation suggested by the Claimant arguing that “the project was not in existence for a sufficient period of time to generate the data necessary for a meaningful DCF calculation.”<sup>189</sup> The Tribunal further argued that “the application of the DCF method [in this case] would... result in awarding “possible but *contingent* and *indeterminate* damages which, in accordance with jurisprudence of arbitral tribunals, cannot be taken into account.”<sup>190</sup> It considered that the application of the method would result in the award of *lucrum cessans* in excess of legitimate lost profits, as the certain profit making operation within the project areas would be illegal under Egyptian and international law for a substantial part of the duration of the project.<sup>191</sup> The Tribunal decided on the basis of what it called the “fair measure of compensation” which was the value of the Claimants investment which included the “out-of-pocket expenses” and a sum for the “opportunity of making a commercial success of the project” which was the Claimant’s share of revenues from lot sales within the project area.<sup>192</sup>

<sup>187</sup> *LETCO*, 26 ILM 647 at 670-76.

<sup>188</sup> *First Amco Asia Award*, Award of November 21, 1984, (1985) 24 ILM 1022; The *Second Amco* Tribunal also determined the value of the lost management right of the claimant according to the DCF methods. *Second Amoco Award*, Final Award of June 1990, reprinted in (1992) XVII YBCA 73 at 103-4.

<sup>189</sup> (1993) ICSID Rev.-FILJ 328 at 381. The ICC award in this case, in the view of the risk inherent in the project had also rejected the DCF method. It decided that the amount of damages would be assessed by taking the amount of actual investment and adding an incremental factor representing the increase in the value of the investment over its actual cost. *SPP v. Egypt*, ICC award of 1983, 86 ILR 535.

<sup>190</sup> *Ibid.* at 382 (footnote omitted).

<sup>191</sup> *Ibid.*

<sup>192</sup> *Ibid.* at 384-9.

In *Starrett Housing Corporation v. Iran*<sup>193</sup> a dispute arising out of a short-term construction contract, <sup>the Tribunal</sup> considered the interference by the respondent in the contract as an unlawful expropriation, and referred the determination of the fair market value of the expropriated property to an expert accountant who based his calculation on the DCF method:

“... to arrive at the Project’s fair market value, the Expert (i) calculated the remaining revenues in the Project, (ii) calculated the remaining costs in the Project, and (iii) applied a discount rate to the resulting cash flow. This discount rate was based on a return on capital expected by a reasonable businessman on 31 January 1980 as well as on the expected rate of inflation, rate of real interest, and rate of risk.”<sup>194</sup>

Khalilian argues that this decision should be seen in the light of the particular facts of the case; that both the Claimant and the Respondent had agreed to the method since the action of the Respondent was illegal and also the fact that the contract was a relatively short-term one and as such in the application of the DCF method the element of speculation is rather limited.<sup>195</sup> It is to be noted that even in this case, the Tribunal ordered damages which were much less than what had been arrived at through the application of the DCF method arguing that “when the circumstances militate against calculation of a precise figure, the Tribunal is obliged to exercise its *discretion to ‘determine equitably’* the amount involved.”<sup>196</sup>

In *Amoco* the Tribunal did not agree with the Claimant’s calculation on the basis of the DCF method arguing that such a calculation

“leaves aside the value of the expropriated assets... The Claimant’s method is instead a projection into the future to assess the amount of the revenues which would possibly be earned by the undertaking, year after year, up to eighteen years later in this case. These forecasted revenues are actualised at the time by way of a discounting calculation, and capitalized as the measure of the compensation to be paid, as well as the alleged market value of the enterprise. With such a method, *lucrum cessans* becomes the sole element of compensation.”<sup>197</sup>

The Tribunal maintained that the value of an enterprise as a going concern should be assessed in relation to the “discrete elements which constitute it” though the result may be higher than the aggregate of such elements, “and therefore to the investment made

<sup>193</sup> *Starrett Housing Corporation v. Islamic Republic of Iran*, Final Award of 14 August 1987, 16 Iran-US CTR 112 at 201.

<sup>194</sup> *Ibid* at 126.

<sup>195</sup> Khalilian, *supra*, note 168 at 47.

<sup>196</sup> 16 Iran-US CTR at 112 (Italics supplied).

<sup>197</sup> *Amoco International Finance*, 15 Iran-US CTR 189 at 259.

in order to create the concern and to maintain its profitability."<sup>198</sup> This method of assessing the market value of an enterprise is totally different from "the capitalisation of the future earnings" which due to the *highly speculative nature* of the method involved, could result in the unjust enrichment of the owner of the expropriated enterprise.<sup>199</sup> Having discussed the uncertainty surrounding the operation of the market in the oil industry and the probability and the consequences of price renegotiations, the Tribunal held:

"As a projection into the future, any cash flow projection has an element of speculation associated with it, as recognised by the Claimant. For this very reason it is disputable whether a tribunal can use it at all for the valuation of compensation. One of the best settled rules of the law of international responsibility of states is that no reparation for speculative or uncertain damage can be awarded. This holds true for the existence of the damage and of its effect as well. Such a rule, therefore, applies in the case of unlawful expropriation. *A fortiori*, the reasoning on which it rests must also apply in the case of compensation for a lawful expropriation. It does not permit the use of a method which yields uncertain figures for the valuation of damages, even if the existence of damages is certain."<sup>200</sup>

Having rejected the applicability of the DCF method of valuation to the facts of the case at hand, the Tribunal noted that such a method may be useful for a prospective investor but certainly not for an arbitral tribunal as a measure of fair compensation.<sup>201</sup> The Tribunal on the choice of a method of valuation considered that "in the view of the purpose to be attained, in order to avoid arbitrary results and to arrive at an equitable legal standard, the use of several methods, when possible, is also commendable."<sup>202</sup>

The Tribunal, in order to adjust the amount arrived at through the application of a valuation method, has in a number of cases taken equitable considerations into account. In *Phillips*, a case involving the assessment of the compensation for the taking of oil company interests, the Tribunal found it understandable to take into consideration all the relevant circumstances including equitable considerations.<sup>203</sup> The Tribunal relied on the result of valuations based on the DCF and the net book value presented by the Claimant and the Respondent respectively and made its decision on

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<sup>198</sup> *Ibid* at 260.

<sup>199</sup> *Ibid*.

<sup>200</sup> *Ibid* at 262.

<sup>201</sup> *Ibid* at 262; See also Khalilian, *supra*, note 168 at 46.

<sup>202</sup> *Ibid* at 256.

<sup>203</sup> *Phillips Petroleum Company Iran v. The Islamic Republic of Iran, The National Iranian Oil Company*, 21 Iran-US CTR 79 at 122.

what it called the “underlying asset valuation approach”.<sup>204</sup>

Although it has in a number of cases acknowledged the inclusion of future profits, the Tribunal has not allowed such profits in cases where the business has not become a going concern or where other circumstances point to the future unprofitability of the concern. Therefore, in *Sola Tiles*, the Tribunal rejected good will and lost future profits payable for expropriation of a luxury tile importing business arguing that the nature of such a business suggested that it was unlikely to continue as a going concern after the Revolution.<sup>205</sup> A similar conclusion was reached by the Tribunal in *Thomas Earl Payne v. Iran*, where it was held that two motion picture film distribution companies were going concerns.<sup>206</sup> However, the Tribunal rejected lost future profits as an element of compensation: “The Tribunal considers that the effects of the Revolution seriously discounted the reliability of past performance as an indicator of likely future profitability for the two companies and value of their good will, particularly since they are service companies.”<sup>207</sup> The Tribunal based the assessment on an *approximation* of value of the Claimant’s interest in the two companies, taking into account all the relevant circumstances of the case.<sup>208</sup> On the award of lost future profits, it has been argued that arbitral tribunals include an amount for profitability instead of lost future profits:

The only way to reconcile the cases is to accept the key principle that lost profits as *lucrum cessans* and as opposed to profitability cannot appropriately be included in the quantum of compensation, though an element attributable to lost profits may sometimes be included as part of *damnum emergens*. It may also be the case that in concession cases an element for *lucrum cessans* may be payable for a lawful deprivation... but even in these cases, in spite of what was said, it is not clear that what was being taken into account was profitability rather than lost profits.<sup>209</sup>

Although arbitral tribunals have often adopted valuation methods which include the lost future profit, in the application of such methods, to reduce the actual amount of compensation, they have taken certain considerations, including those of equity, into

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<sup>204</sup> *Ibid.* at 123.

<sup>205</sup> *Sola Tiles, Inc. v. Islamic Republic of Iran*, 14 Iran-US CTR 223 at 240-41.

<sup>206</sup> *Thomas Earl Payne v. The Government of the Islamic Republic of Iran*. 12 Iran-US CTR 3.

<sup>207</sup> *Ibid.* at 15.

<sup>208</sup> *Ibid.*

<sup>209</sup> Amerasinghe, , *Issues of Compensation* , *supra*, note 133 at 61.

account which has resulted in the reduction of the final amount.<sup>210</sup> Lauterpacht is highly critical of allowing considerations of equity to influence valuation as an *objective* process:

There are thus really two separate criticisms that may be levelled against the approach of the chamber. First, in the part of the decision dealing with valuation (as opposed to the level of compensation), use is made of language relevant to the standard of compensation. The suggestion that the standard of compensation payable upon a lawful nationalisation or expropriation is determined by reference to equity is one which, though one may not accept it as the standard presented by the relevant treaty, cannot be said to be conceptually out of order. But, to the extent that equity is given an additional and earlier role by applying it to the process of *valuation*, error creeps in.<sup>211</sup>

On the way arbitral tribunals have tried to order something less than adequate, prompt and effective compensation, Higgins mentions their reluctance "to insist on one particular method of valuation over another."<sup>212</sup> Given the assumed relationship between valuation methods and the theory of compensation, it may be argued that arbitral tribunals in such cases have in effect refused to order full compensation.

## 5.5 Conclusions

Often based on the recognition of sovereignty of states, arbitral tribunals have taken the view that restitution in kind and declaration of rights amounting to restitution, are not remedies of international law for nationalisation of concession rights of aliens. Compensation is the primary remedy ordered in arbitration of state contract disputes.

The study of major arbitral awards reveals that while, in principle, they support the full standard of compensation, a trend is emerging in favour of qualifying the standard in the light of particular circumstances of each case. However, from the few awards, it is hard to set out with certainty a list of such circumstances. The fact that, even in cases where standard of full compensation is apparently applied, arbitral tribunals often, through various means including their flexible approach towards the choice of a valuation method and its application, have reduced the actual amount to a lower level may be interpreted as their recognition of the inappropriateness of the standard of full compensation for nationalisation. However, since in such awards this result is often

<sup>210</sup> See *Marine Drive Complex v. Ghana*, Awards of 27 October 1989 and 30 June 1990, reported in (1994) XIX YBCA 11 at 28-29

<sup>211</sup> Lauterpacht, *supra*, note 163 at 134.

<sup>212</sup> Higgins, *The Taking of Property by the State*, *supra*, note 50 at 293.

achieved through means other than express ruling on the standard of compensation, it appears that arbitral tribunals have not been prepared to *expressly* depart from the notion of full compensation.

Given the recognition by the relevant laws of the right of states to take contract rights of private parties to state contracts, and considering the fact that the only practical remedy in such cases is compensation, the standard of compensation for nationalisation is often the main legal issue in state contracts arbitrations. In the absence of any coherent rule of law in this area, in the light of the diversity of nature of the cases and the circumstances involved, the case-by-case basis of determinations of the question by arbitral awards may be somewhat justified. It, however, results in the grant of a high degree of discretion to arbitral tribunals in their determination of the amount of compensation which may, in the light of the importance of the issue, render the whole process highly subjective. This, in turn, could give rise to the possibility of the arbitral tribunal ordering such measures of compensation which could effectively amount to a denial of the state's right to exercise its prerogatives. Clear emphasis by arbitral tribunals on the public requirement of state contracts as the ground for the order of an amount less than full compensation, and further elaboration on the relevant circumstances requiring such standard of compensation could exclude such a possibility.

## Chapter VI

### Recognition and Enforcement of Awards

#### 6.1 Introduction

Parties entering an arbitration agreement, do so with the expectation of having their dispute settled through the binding decision of the judge of their own choice i.e. the arbitrator. This decision -award- would be of little use if it could not be put into effect in the case of non-compliance by the losing party.<sup>1</sup> Recognition and enforcement machineries aim to provide such an effect for arbitral awards when the award losing party does not voluntarily comply with them.<sup>2</sup> In relation to state contracts, arbitration is primarily insisted upon by the private parties as a means of protection of private interests against the state party's interference with the contract.<sup>3</sup> On the other hand, the state party is primarily concerned with the exercise of its sovereign prerogatives in that it would oppose the enforcement of awards made in violation of such prerogatives. This chapter deals with the question of the extent of the enforceability of awards made in arbitration of state contracts.

Every state decides for itself whether or not to enforce foreign or international

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<sup>1</sup> The term award has not been defined by the relevant conventions and rules such as the New York Convention. This is perhaps due to the difficulty of having a definition which could include both interim and final awards. One may describe an award as the ultimate expected result of an arbitration proceeding which is a binding decision of the arbitral tribunal that will dispose wholly or partially of the matters upon which the tribunal has jurisdiction. Depending on the arbitrator's decision as to whether to dispose of all the issues involved in the case in the same award or part of them, the rendered award will be final or interim. The New York Convention does not mention this categorisation. Art.32 of UNCITRAL Arbitration Rules however provides for different types of awards including interim awards. The text of the Article seems to suggest that the drafters had different meanings for final awards in paras.(1) &(2) as in the first one final awards form a category distinct from other conceivable awards. Whereas the latter paragraph requires arbitral tribunals to render only final awards. Interim awards are usually rendered during the course of proceedings as to the issues which can be decided at that stage such as jurisdiction. Redfern, A. and M. Hunter, *Law and Practice of International Commercial Arbitration*, London: Sweet and Maxwell 1991 at 375.

<sup>2</sup> As far as the meaning of recognition and enforcement are concerned it is noted that recognition is a defensive process whereby fresh proceedings with respect to a matter on which there has already been an arbitral award, is barred. The recognition of an award as *res judicata* was upheld in the English case *Dallal v. Bank Mellat*, where one party tried to relitigate an award and it was considered as "abuse of the the process of the court". (1986) 2WLR 745 (QBD) By contrast, the enforcement process is used to ensure that the award is complied with and is put into effect. To that end legal sanctions are employed by the enforcing court. There have been arguments as to whether such distinction is of any relevance and practical use in the contemporary practice of international commercial arbitration. Toope, S., *Mixed International Arbitration: Studies in Arbitration between States and Private Persons*, Cambridge: Grotius 1990 at 101. The distinction would result in having an award against a state recognised even if the state may successfully plead sovereign immunity and bar execution of award. Also, the distinction is of relevance in the case of declaratory awards which need no enforcement. Perhaps, it was for such reasons that the ICSID Convention, in the face of opposing arguments, retained the distinction. Art.53(3) of the Convention.

<sup>3</sup> See Ch. I, *supra*, 1.3.4.

awards in its territory since the issue touches upon the sovereignty of states and might have some public policy implications.<sup>4</sup> The matter traditionally has been addressed in the context of recognition and enforcement of foreign judgments.<sup>5</sup> All the existing rules and methods concerning the recognition and enforcement of awards seek to achieve their purpose through domestic laws.<sup>6</sup> Even the Washington Convention on the Settlement of Disputes between States and Nationals of Other States,<sup>7</sup> as an instrument of international law which reflects the agreement of the contracting states, among other things, to waive certain prerogatives of national courts, provides for the enforcement of awards in this way.<sup>8</sup> The position is generally the same in the case of recognition and enforcement of awards rendered in international commercial arbitration i.e. the recognition and enforcement of such awards is also accomplished through domestic courts.

Below, recognition and enforcement of state contracts awards under the regimes of the New York Convention, the ICSID and the Iran-US Claims Tribunal will be studied.

### 6.1.1 New York Convention<sup>9</sup>

To facilitate an understanding of the Convention, it is appropriate to provide a brief review of its historical context. Recognition and enforcement of a domestic award does not normally pose any difficulties since the place of rendition of the award and that of

<sup>4</sup> See, in general, Reisman, M.W., *Systems of Control in International Adjudication and Arbitration*, Durham/London:Duke University Press 1992, esp. at 139.

<sup>5</sup> For a comprehensive treatment of recognition and enforcement of foreign judgments see Von Mehren, A., *Recognition and enforcement of foreign judgments- General theory and the role of jurisdictional requirements*, (1980) 167 RCADI 9.

<sup>6</sup> It may be argued that the Algiers Accords provide for an anational machinery for enforcement of awards resulting from state contract disputes. However, such a contention is not free from challenge. The enforcement machinery of the Tribunal, covers only a certain category of the Tribunal's awards i.e. awards rendered against Iran. As for other awards of the Tribunal, the need for domestic enforcement machineries remains.

<sup>7</sup> Signed 18 March 1965, entered into force 14 October 1966, 575 UNTS, 160.

<sup>8</sup> Art.54(2).

<sup>9</sup> New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 1958, United Nations Treaty Series (1959) Vol. 330, 38, reproduced in Wetter, *International Arbitral Process*, New York: Dobbs Ferry 1979, at 308. By July 1994, 97 countries had acceded the Convention. For a list of those countries see the Scoreboard produced in (1994) 9 News and Notes from the Institute for Transnational Arbitration, no.3.

a certain procedure to be followed in order to have an award enforced.<sup>10</sup> For a long time domestic legislation and national courts followed almost the same procedure for the recognition and enforcement of foreign awards. There were, however, significant differences between diverse national laws on the matter. The most usual method was to grant recognition upon the issuance of an award. The enforcement however would require some kind of filing of the award with a public authority.<sup>11</sup> The application of different national legislations to foreign awards would result in a diversity of treatment that an award would receive in different jurisdictions; hence a need for the harmonisation of national laws on the question of the recognition and enforcement of foreign awards.<sup>12</sup>

The first multilateral attempt, the Geneva Protocol on Arbitration Clauses of 1923, did not go as far as creating such a system.<sup>13</sup> According to Art.3 of the Protocol, states were to treat foreign awards as having the nationality of the place where the enforcement is sought. In other words, foreign awards would be treated as national. As Luzzatto puts it, the Convention considered having the nationality of a contracting state as "a prerequisite for recognition and enforcement."<sup>14</sup> The next step was the conclusion of the 1927 Geneva Convention for the Execution of Foreign Awards,<sup>15</sup> according to which contracting parties were under an obligation to recognise and enforce any arbitral awards covered by the 1923 Protocol "in accordance with the rules of the procedure of the territory where the award is relied upon".<sup>16</sup> In order to obtain such recognition and enforcement, the party seeking recognition and enforcement had to prove that certain conditions had been met including that the submission to arbitration had been valid

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<sup>10</sup> For example, in England the award winning party must first have the award converted into a judgment or an order. Mustil, R. and Boyd, *The law and practice of commercial arbitration in England*, 1982 at 416. There are two ways to obtain such a judgment or order. First, by bringing an action for breach of the implied promise contained in the arbitration agreement to perform a valid award. Second, by applying for an order giving leave to enforce an award or for a judgment in terms of the award. *Ibid* at 416-441.

<sup>11</sup> Awards governed by Italian law have no legal effect unless deposited with the Registry of the lower court (*Pretore*) within five days from the date of rendition of the award. Luzzatto, *International Arbitration and Municipal Law of States*, (1977) 157 RCADI 9 at 67.

<sup>12</sup> *Ibid*.

<sup>13</sup> Protocol on Arbitration Clauses, 27 LNTS 157 reproduced in Wetter, *supra*, note 9, Vol. V at 301.

<sup>14</sup> Luzzatto, *supra*, note 11 at 69.

<sup>15</sup> Signed 26 September 1927, entered into force 25 July 1929, reproduced in Wetter, *International Arbitral Process*, Vol. V, *supra*, note 9 at 304.

<sup>16</sup> Art.I of the Convention.

under the applicable law, that the subject matter was capable of settlement by arbitration under the laws of the enforcing country, that the award was final in the country of origin and its enforcement would not contravene the public policy of the enforcing state.<sup>17</sup> The Convention placed a heavy *burden of proof* on the party seeking enforcement to prove all of the above, and even upon their fulfilment, the court could still refuse to grant recognition and enforcement on the grounds set out in Art.II.<sup>18</sup>

The 1927 Geneva Convention was clearly an important step forward as it was the first multilateral convention to deal with the question of recognition and enforcement of foreign arbitral awards. However the difficulties involved in the application of the Geneva Convention made the ICC focus its effort on the introduction of a new convention which would shift the *burden of proof* and also eliminate the element of *nationality* of awards so that anational or delocalised awards could also be covered. The 1958 New York Convention on Recognition and Enforcement of Foreign Arbitral Awards was the result of negotiations and bargaining which followed the introduction of this draft.<sup>19</sup>

The main purpose of the draft was to introduce a regime of recognition and enforcement of international arbitral awards i.e. awards which had no link to national laws - awards without any nationality.<sup>20</sup> However, having faced strong opposition, the draft had to be modified. The final outcome was the conclusion of the New York Convention which provides for a regime of recognition and enforcement of foreign

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<sup>17</sup> Art.I.

<sup>18</sup> Art. II provides:

"Even if the conditions laid down in Article I hereof are fulfilled, recognition and enforcement of the award shall be refused *if the Court is satisfied:*

- (a) That the award has been annulled in the country in which it was made;
- (b) That the party against whom it is sought to use the award was not given notice of the arbitration proceedings in sufficient time to enable him to present his case; or that, being under a legal incapacity, he was not properly represented;
- (c) That the award does not deal with the differences contemplated by or falling within the terms of the submission to arbitration or that it contains decisions on matters beyond the scope of the submission to arbitration.

If the award has not covered all the questions submitted to the arbitral tribunal, the competent authority of the country where recognition or enforcement of the award is sought can, if it think fit, postpone such recognition or enforcement or grant it subject to such guarantee as that authority may decide (italics supplied)."

<sup>19</sup> Van den Berg, A., *The New York Convention of 1958: Towards a Uniform Judicial Interpretation*, The Hague: T.M.C. Asser Institute, 1981, 6-8.

<sup>20</sup> Glossner, O., *The Conduct of ICC Arbitration*. In Lew, J., *Contemporary Problems in International Arbitration*, Edited by J. Lew, London: Queen Mary College 1986, 210 at 213.

awards i.e. awards which have a nationality other than that of the country of enforcement.<sup>21</sup> Therefore, as its title suggests, the Convention did not go as far as the objectives set by the ICC i.e. disconnecting the award from the place where it is made or the law according to which it is made. Neither did it fulfil the format proposed by the *Unidroit* put forward earlier to give "international significance" to the exequatur issued in the country where the award was made so that the enforcement of the award would be automatically allowed by all other member states, unless the award was contrary to their public policy.<sup>22</sup>

According to Art.I, the Convention "shall apply to the recognition and enforcement of arbitral awards made in the territory of a state other than the state where the recognition and enforcement of such awards are sought" as well as to "arbitral awards not considered as domestic awards in the State where their recognition and enforcement are sought." Art.III puts the Contracting States under an obligation to recognise "arbitral awards as binding and enforce them in accordance with the rules of procedure of the territory where the award is relied upon," and that there should not be any substantially more onerous conditions for the recognition and enforcement of a foreign award than those imposed on the recognition and enforcement of domestic awards. Art. IV sets out a modest list of documentary evidence which must be produced by the party seeking recognition and enforcement of the award. This includes: (a) the duly authenticated original arbitration agreement or a duly certified copy thereof; and, (b) the original arbitral award or a duly certified copy of it. Art. IV of the New York Convention marks a departure from the similar provision of the Geneva Convention which requires the party seeking recognition and enforcement to put forward the necessary documentary evidence to *prove* certain matters such as the validity of the submission to arbitration under the relevant applicable law, the finality of the award in the country of its origin, etc.<sup>23</sup> For a party invoking an award under the New York Convention it will be enough to collect the documents mentioned in Art. IV, i.e. the award and the arbitration agreement, which will be *prima facie* evidence that

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<sup>21</sup> Luzzatto, *supra*, note 11 at 70-1. Anational awards will be dealt with in greater detail in further parts of this chapter.

<sup>22</sup> On this point see David, R., *Arbitration in International Trade*, Deventer/London: Kluwer 1985 at 402.

<sup>23</sup> Art. 1 of the 1927 Geneva Convention.

an enforceable award has been rendered.<sup>24</sup>

According to the New York Convention, the party objecting to the recognition and enforcement of the award should furnish the evidence that recognition and enforcement should be refused on one of the grounds set out in Art.V. Therefore, the Convention has shifted the *burden of proof* from the party relying on the award to the defendant at the recognition stage.

Recognition and enforcement of awards may be refused in the case of: (a) incapacity of the party at the time of the arbitral agreement; (b) lack of proper notice of the appointment of the arbitrator or of the arbitration proceedings; (c) an award dealing with differences not covered by the arbitration agreement; (d) the composition of the arbitral authority or the arbitral procedure was not in accordance with the agreement of the parties, or, failing such agreement was not in accordance with the law of the country where the arbitration took place; and, (e) the award was not final.<sup>25</sup> Courts would consider challenges based on the above grounds only when they are invoked by the award-losing party. As well as the above, there are two other grounds on which courts, at their own discretion, may refuse recognition and enforcement of an arbitral award. These are arbitrability, and public policy according to the law of the enforcement forum.<sup>26</sup>

From the study history and provisions of the Convention, it would appear that it has been introduced to deal with the awards of private arbitration. It does not make any specific reference to awards resulting from arbitration of state contracts disputes.

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<sup>24</sup> David, *supra*, note 22 at 396.

<sup>25</sup> Art.V(1).

<sup>26</sup> Art.V(2) of the New York Convention. The 1961 European Convention on International Commercial Arbitration was the next multilateral convention with the aim of facilitating trade between Eastern and Western Europe. Reproduced in Wetter, *International Arbitral Process*, *supra*, note 9 at 316. The Convention limited the grounds for refusal of enforcement set by the N.Y. Convention, by restricting the application of Art.V(1)(e) of that convention. According to this article a court may refuse recognition and enforcement of an award when it has already been set aside by a court of the other country where it was made for whatever reason. The similar provision of the Geneva Convention limits such refusal only to when the award has been set aside for reasons enumerated in Article IX(1). The 1961 Convention, however, has been criticised for being "too complicated" and also for its limited application - basically European - especially in the case of state contracts where parties often are from both developed and developing countries. Van den Berg, *New York Convention of 1958*, *supra*, note 19 at 9.

### 6.1.2 ICSID Regime

A further initiative which is of direct relevance to the type of disputes which are the subject of our study was the conclusion of the Convention on the Settlement of Investment Disputes between States and Nationals of other States.<sup>27</sup> ICSID arbitration awards do not bear any nationality as they arise from an arbitration system agreed upon at the international level. The Contracting States have agreed to enforce such awards within their territories with a minimum of formality: "[T]he award shall be binding on the parties and shall not be subject to any appeal or to any other remedy except those provided for in this Convention".<sup>28</sup> Under Art.54(1) "each contracting state shall recognise an award rendered pursuant to this Convention as binding and enforce the pecuniary obligations imposed by that award within its territories as if it were a final judgment of a court in that state". To take advantage of the ICSID enforcement machinery, the state party to the contract must have ratified the Convention and must have submitted to the Jurisdiction of the ICSID in writing. The scheme of the ICSID enforcement regime points to the desire of the drafters to formulate a procedurally self-contained arbitration regime which would be truly international i.e., without any dependency or reliance on national procedural laws. Art.54(3) however retains an important role for national laws. It subjects the execution of the award to "the laws concerning the execution of judgments in force in the State in whose territories such execution is sought." The importance and relevance of national laws of that state becomes more apparent in relation to the execution of awards against states. Art. 55 states:

"Nothing in Art. 54 shall be construed as derogating from the law in force in any Contracting State relating to immunity of that State or of any foreign State from execution."

This distinction between recognition and execution is due to the difference between the underlying rationales of the two notions and the sensitive issues which may arise in relation to the measures of execution against foreign states.<sup>29</sup>

<sup>27</sup> Signed 18 March 1965 entered into force 14 October 1966, 575 UNTS 160.

<sup>28</sup> Art.53(1).

<sup>29</sup> Further elaboration of this point below under sovereign immunity.

### 6.1.3 Iran-US Claims Tribunal<sup>30</sup>

It is frequently claimed that the most unique feature of the Tribunal is the mechanism provided by the Algiers Accords for the enforcement of its awards i.e. the establishment of a security account which provides the funds for the payment of certain monetary awards rendered against Iran.<sup>31</sup> Therefore, for a claimant in possession of such an award, there would be no need to resort to any conventional means of recognition and enforcement of awards. However, it should be borne in mind that not all awards rendered by the Tribunal are subject to the same regime of enforcement. According to the accords, awards resulting from the arbitration of claims by Iranian nationals against the US Government and those resulting from claims by either governments against the other shall be enforceable against either government in the courts of any nation in accordance with its laws.<sup>32</sup> This could also apply to other awards of the Tribunal, should the Security Account run out of funds.<sup>33</sup> Therefore, as to such awards the conventional methods of recognition and enforcement would prevail.<sup>34</sup> There have been a number of awards rendered against the U.S. claimants. Iran has found it extremely difficult to have such awards enforced in the United

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<sup>30</sup> For commentary on recognition and enforcement regime of the Tribunal's awards see Avanesian, A. B., *Iran-United States Claims Tribunal in Action*, Dordrecht:Graham & Trotman 1993, 291; Lake and Tucker, *Judicial Review of the Iran-US Claims Tribunal: Are the Tribunal's Awards Dutch?*, (1984) 16 *Law and Policy in International Business* 755; Lewis, R., *What goes comes back: Can Iran Enforce Awards of the Iran-US Claims Tribunal in the United States*, (1988) 26 *Columbia Journal of Transnational Law* 515; Seifi, J., *Procedural Remedies against Awards of Iran-United States Claims Tribunal*, (1992) 8 *Arbitration International* 41.

<sup>31</sup> 19 January 1981, reprinted in 1 *Iran - US CTR* (1981) 3, para.7. The Security Account was established with the NV Settlement Bank of the Netherlands, a subsidiary of De Nederlandsche Bank (the Dutch Central Bank) acting as a depository bank. See *Technical Agreement with the NV Settlement Bank of the Netherlands* 1981, reprinted in (1981) 1 *Iran -US CTR* Upon issuance of an award the President of the Tribunal notifies the Escrow Agent, the Central Bank of Algeria of such an award and its particulars including the number of the claim, the name and address of claimant, the amount of the award and interest. The Escrow Agent then will instruct the Depository Bank i.e. N.V. Settlement Bank which will make the payment according to the instructions. According to para 1(e)(iii) of the Technical Agreement, the Depository bank will not be liable for the payment of awards which were subsequently challenged, revoked, set aside, or modified.

<sup>32</sup> Art. VI of the Claims Settlement Declaration.

<sup>33</sup> Iran is under an obligation to maintain a minimum balance of US \$500 million in the Account. The Security Account will operate "until the President of the Arbitral Tribunal has certified to the Central Bank of Algeria that all arbitral awards against Iran have been satisfied in accordance with the Claims Settlement Agreement, at which point any amount remaining in the Security Account shall be transferred to Iran".

<sup>34</sup> As regards the enforcement of awards rendered against either of the Governments, Art. IV(1) of the Claims Settlement Declaration provides: "Any award which the Tribunal may render against either government shall be enforceable against such government in the courts of any nation in accordance with its laws."

States.<sup>35</sup> In 1985, Iran filed a request with the Tribunal regarding the US commitment to satisfy awards rendered in favour of Iran. The Islamic Republic of Iran and the United States of America, Case No. A/21. Iran argued that (i) Art.IV(1) of the CSD which considers the Tribunal awards as “final” and “binding” imposed an obligation on the United States to satisfy such awards, that the Accords established a “reciprocal system of commitments” according to which the United States had to pay awards if its nationals failed to do so, that having espoused the claims of its nationals, the United States had “the obligation to satisfy Tribunal awards against such nationals and that the obligation of the United States was one of “result” which was the assured enforcement of Tribunal awards rendered against its nationals without the need for Iran to take any action to secure enforcement.<sup>36</sup> The Tribunal, arguing that “ a “final” and “binding” award is one with which the parties must comply and which is ripe for enforcement, thus when a party fails to comply voluntarily with a final and binding arbitral award, the other party is free to seek enforcement of the award through municipal court procedures”, rejected Iran’s contentions.<sup>37</sup> However the Tribunal warned the United States that “if it were to be established that recourse by Iran to the mechanisms or systems existing in the United States had not resulted in the enforcement of awards of this Tribunal against United States nationals would the question arise as to what further measures, if any, the United States might be required to take in order to ensure the “effectiveness” of the Algiers Declarations.”<sup>38</sup>

In *Iran Aircraft Industries v. Avco Corporation*, a US appeal court affirmed a lower court’s decision denying recognition and enforcement to an award of the Tribunal in favour of the Iranian claimant on the ground that Avco had been denied an opportunity to present its claim in a meaningful manner before the Tribunal.<sup>39</sup> Iran has filed a statement of claim against United States arguing that the United States is in violation of its commitments concerning the enforcement of the Tribunal awards rendered in favour

<sup>35</sup> For a detailed study of the issue see Lewis, *supra*, note 30 at 515.

<sup>36</sup> *Ibid.* at 520.

<sup>37</sup> *Ibid.* at 521-2.

<sup>38</sup> *Ibid.* at note 45.

<sup>39</sup> (1993) XVIII YBCA U.S. no.143 at 596.

of Iran.<sup>40</sup>

According to the Tribunal's Rules, parties may, before the award is made, agree on a settlement of the dispute in which case the Tribunal, on the request of the parties, issues an award on agreed terms.<sup>41</sup> The Tribunal in case A/1 considered questions of its jurisdiction on this matter and its power of refusal to record such awards and held that it would examine its jurisdiction on a case-by-case basis.<sup>42</sup> On the second issue the Tribunal was of the view that '[A]lthough the Tribunal, when deciding on a request under Article 34, should not attempt to review the reasonableness of the settlement in the place of the arbitrating parties, the Tribunal can refuse to record a settlement in the form of an award, provided that it does not act arbitrarily'.<sup>43</sup> To date, there have been a number of awards on agreed terms recorded by the Tribunal.<sup>44</sup> This mechanism has been criticised on the ground that it might be used by the parties to extract money from the Security account on the basis of the parties' settlement on matters which are not within the jurisdiction of the Tribunal. It would prejudice other claimants since such awards, on the request of the parties, can be treated as confidential and in that there will be no chance for others to see whether the payment was related to the particular claim or was a part of new transaction between the parties.<sup>45</sup>

In *Pan American World Airways, Inc. v. Iran*, an award on agreed terms between the Claimant and the Ministry of Defence of Iran, was recorded by the Tribunal.<sup>46</sup> According to the award, a payment would be made to the claimant from the Security Account on delivery of specified goods. The award was to be treated as strictly confidential.<sup>47</sup> Judge Holtzmann, in a dissenting opinion expressed his dissatisfaction with the majority on three points, jurisdiction, confidentiality and the fact that failing delivery of goods by Pan Am, the funds from the security account were to be paid to

<sup>40</sup> Case A/27. (1994) XIX YBCA 371.

<sup>41</sup> Art. 34 of the Tribunal's Rules, 1 Iran -US CTR (1983), at 83.

<sup>42</sup> Iran-United States, case A/1, 1 Iran - US CTR (1983), 144 at 152.

<sup>43</sup> *Ibid* at 153.

<sup>44</sup> An updated list of awards on agreed terms appears in Iran-United States Claims Tribunal Reports, Cambridge:Grotius.

<sup>45</sup> Dissenting opinion of judge Holtzmann in *Pan American World Airways, Inc. et al v. The Government of Islamic Republic of Iran*, 4 Iran - US CTR (1983), 205 at 206.

<sup>46</sup> *Ibid*.

<sup>47</sup> *Ibid*.

Iran which would be contrary to paragraph 7 of the Declaration of Algeria requiring that the funds in the Security Account 'are to be used for the sole purpose of securing the payment of ...claims *against* Iran'(italics added).<sup>48</sup>

On the issue of its jurisdiction to record awards on agreed terms, the Tribunal had already in case A/1 noted that only claims pending before the Tribunal and within its jurisdiction could be settled by the arbitrating parties.<sup>49</sup> However this does not include cases in which the request for an award on agreed terms is made by the two Governments. In such cases, the Tribunal has expressed the view that it could record awards concerning even certain claims which were *not* pending before the Tribunal and therefore, the Tribunal did not have jurisdiction over them. The Tribunal considered the Joint Request of the two Governments for an award on agreed terms as constituting 'a waiver of any objections they could have to payment pursuant to the Award from the Security Account with respect to claims not pending before the Tribunal'.<sup>50</sup> This is entirely in conformity with the view which considers the Tribunal as an interstate one dealing with international claims. The main contribution of the enforcement machinery of the Tribunal i.e. the security account should not be exaggerated for it only materialised due to the particular circumstances pertinent to the Tribunal.

## 6.2 Limitations to Recognition and Enforcement of State Contracts Awards

A party seeking recognition and enforcement of an award resulting from an arbitration of a state contract dispute in a country other than the country of origin may face a number of obstacles. An anational award arising from the arbitration of a state contract dispute may be denied recognition and enforcement for want of nationality. Public policy, sovereign immunity and Act of State Doctrines may also be of obstructive effects in the process of recognition and enforcement of awards. The source of such limitations is normally the law of the country where recognition and enforcement of the award is sought.

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<sup>48</sup> *Ibid.* at 207.

<sup>49</sup> Case A/1, (1983) 1 Iran- United States CTR 14 at 152.

<sup>50</sup> 1 Iran - US CTR , at 284.

### 6.2.1 Anational Awards

A 'delocalised' or 'anational' award has been defined as "an award resulting from an arbitration which is detached from the ambit of a national arbitration law by means of a specific agreement of the parties."<sup>51</sup> Therefore, an 'anational' award is the result of a 'delocalised' arbitration. To delocalise awards, it is argued, "means to remove the power of the courts at the place of arbitration to make an internationally effective declaration of the award's nullity."<sup>52</sup> As noted in chapter III, delocalisation of arbitration is achieved either with the permission of the relevant national law e.g. Belgian law, or through an international agreement in the case of arbitrations such as those conducted by the ICSID or the Iran-US Claims Tribunal. In relation to the resolution of state contracts disputes, it was noted that, in principle, a delocalised commercial arbitration is not compatible with the public requirement of state contract disputes. Below, the effectiveness of awards made by delocalised arbitrations is examined.

#### *New York Convention*

The applicability of the New York Convention to awards made by delocalised private arbitrations is highly questionable. An arbitral award could derive its binding force either from the national law of the place of rendition by virtue of a confirmation, or by being considered as having a contractual nature, and would thus derive its binding force from the law of the place of conclusion of the contract which again will be the law of the place of rendition of the award. It is difficult to consider the arbitration agreement as being the sole source of binding force of the award. From the study of the Convention it would appear that it was primarily drafted to cover foreign awards -awards with a nationality other than that of the enforcing country. For example, Art.V(1)(a) considers the invalidity of the agreement as grounds for refusal of recognition and enforcement under the applicable law chosen by the parties and in

<sup>51</sup> Van den Berg, A., *Recent Enforcement Problems under the New York and ICSID Conventions*, (1989) 5 *Arbitration International* 2 at 5.

<sup>52</sup> Paulsson, J., *The Extent of Independence of International Arbitration from the law of the situs*, in *Lew, Contemporary Problems in International Arbitration*, In *Contemporary Problems in International Arbitration*, London: Queen Mary's College 1986, at 141.

the absence of such choice 'under the *law to which the parties have subjected it* or , failing an indication thereon, under the *law of the country where the award was made* ' (italics supplied). Conflict rules contained in this article indicate that the drafters of the Convention considered the award as having a municipal law as its governing law. It is to be noted that in cases where the invalidity of the arbitration agreement was disputed courts almost always placed emphasis on the application of the second part of the conflict rules of the article and decided that the arbitration agreement is governed by the *lex loci arbitri*.<sup>53</sup>

Art.V(1)(d), in the context of the composition of the arbitral authority or the arbitral procedure, also makes reference to the law of the country where the award was made. It states that recognition and enforcement of an award may be refused when "the composition of the arbitral authority or the arbitral procedure was not in accordance with the agreement of the parties, or, failing such agreement, was not in accordance with the law of the country where the arbitration took place". It may be argued that the above provision is an indication that the New York Convention applies to 'anational' awards since according to the parties' agreement regarding the procedure of arbitration prevails over the *lex loci arbitri*. However, from the drafting history of the Convention and the fact that, despite the proposals of the ICC, the Convention chose to cover 'foreign awards' instead of 'international awards' one can conclude that the Convention has been designed to address the question of recognition and enforcement of those arbitral awards which are rendered generally pursuant to the application of some national procedural law, most often, the law of the place of arbitration.<sup>54</sup>

Another argument for the non-applicability of the New York Convention to "anational" awards is based on Article V(1)(e) which provides that an award may be refused recognition and enforcement if it " has not become binding on the parties, or

<sup>53</sup> Commentary, 16 YBCA (1991), 493.

<sup>54</sup> Luzzatto, *supra*, note 11; Glossner, *The Conduct of ICC Arbitration*, *supra*, note 20 at 213; Van den berg, *Recent Enforcement Problems*, *supra*, note 52 at 9. The question may arise in the case where the composition of the tribunal and the procedure chosen by the parties do not meet the requirements of the *lex loci arbitri*. Van den Berg is of the opinion that in such cases the national law of the place of arbitration would override the agreement of the parties. *Ibid.* at 10. He illustrates the situation in the case of an award rendered by a tribunal set up, due to default of one party to choose his arbitrator, according to the relevant English law and place of arbitration, namely London. In case the composition of the tribunal does not correspond with the wish of the parties reflected in the agreement, the award should be refused recognition and enforcement in other countries on the ground mentioned in Art.V(1)(d).

has been set aside or suspended by a competent authority of the country in which, or under the law of which, that award was made." Therefore, for an award to be enforceable it has to be binding in the country of origin.<sup>55</sup>

The *Hoge Raad* (the Dutch supreme court) in the famous case *Societe Europeenne D'Etudes et d'Enterprise (SEEE) v. Yugoslavia* considered an award of the arbitration held in the Canton of Vaud as 'anational' and enforceable under the New York Convention.<sup>56</sup> The grounds for considering the award anational was that the court of the place of arbitration, the Cantonal Court of Vaud, had not accepted an action for setting aside the award arguing that it was not an award within the meaning of its law.<sup>57</sup> However, in another judgment the *Hoge Raad* refused to recognise the award as it regarded its non-acceptance by the Cantonal Court of Vaud as setting aside the award and therefore was a ground for the refusal of recognition and enforcement under Art.V(1)(e) of the Convention.<sup>58</sup> It is not easy to infer from the latter judgment that the award was considered 'anational' as the award could have only been set aside under the national law of the place of arbitration and therefore subjected to that law.

The French Court of Appeal of Rouen in later proceedings related to the same case regarded the award as binding within the meaning of the New York Convention, despite its lack of conformity with the arbitration law of the place of arbitration, namely as to the number of arbitrators.<sup>59</sup>

Another case frequently cited by the supporters of 'anational' awards and the applicability of the New York Convention thereto is *Gotaverken*.<sup>60</sup> In this case the French court did not apply the procedure for the challenge of a national award in the

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<sup>55</sup> On the meaning of 'binding' the history of the Convention shows that it was used instead of the term 'final' used by the 1927 Geneva Convention. Final awards in many countries needed leave of enforcement from the court of the country of origin. To avoid the resulting 'double exequatur', the New York Convention used the word 'binding'. Commentary, (1991)16 YBCA at 501.

<sup>56</sup> Judgment of 26 October 1973, *Hoge Raad, Nederlandse Jurisprudentie*, No.361 (1974), reported in 1 YBCA (1976), 197.

<sup>57</sup> *Ibid.*

<sup>58</sup> Judgment of 7 November, 1975, *Hoge Raad, Nederlandse Jurisprudentie*, No.174 (1976), reported in 1 YBCA (1976), 198.

<sup>59</sup> *SEEE v. Banque Mondiale de Yougoslavi, Etat Francais*, Judgment of November 1984, *Cour d'Appel*, Rouen, reported in 11 YBCA (1986), 491.

<sup>60</sup> *Libyan Maritime Co.v. Gotaverken Arendal, Cour d'Appel de Paris*, February 1980, reprinted in (1981) 20 ILM 884.

case of an arbitration held in Paris. The court considered the award as not being French because it involved 'the interests of international commerce' and that "the parties did not designate a procedural law to be applicable apart from the Rules of procedure established by the arbitral institution; and that the arbitrators did not make such a designation either."<sup>61</sup> The Court, therefore, did not hear the challenge to the award on the grounds of lack of jurisdiction.<sup>62</sup>

In *Pablak Ticaret v. Norsolor*, the *cour de cassation* upheld the enforcement of an award which had already been set aside in the country of origin.<sup>63</sup> Some commentators have interpreted this decision of the court as an application of the New York Convention to delocalised awards.<sup>64</sup> It should be noted however that the Court relied on the "more-favourable-right" provision of Art. VII(1) which makes it possible for a party to base their request for the enforcement of an arbitral award on the domestic law concerning the enforcement of foreign arbitral awards of bilateral or other multilateral treaties, instead of the New York Convention.<sup>65</sup> This interpretation of the case is more consistent with a prior decision of the French Court of Appeal, where it quashed the lower court's decision granting recognition to an award which was subsequently set aside in the country of its origin.<sup>66</sup> A recent case which dealt with this issue is *Gould v. Ministry of Defence of the Islamic Republic of Iran*.<sup>67</sup> The relevant point of the case here is the recognition by the Court of Appeals for the Ninth Circuit of the applicability of the New York Convention to 'anational' awards.<sup>68</sup> Responding to the argument that

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<sup>61</sup> *Ibid.*

<sup>62</sup> A similar conclusion was reached by a US Court in *Bergsen* where the United States Federal Court of Appeals for the Second Circuit held that an award arbitration between two foreign parties held in New York was enforceable in the United States under the N.Y. Convention. *Bergsen v. Joseph Müller Corp.* (1983) 710 F.2d 928 (2 Cir.)

<sup>63</sup> Decision of 9 October 1984, (1985) 24 ILM 360.

<sup>64</sup> Toope, *supra*, note 2 at 122.

<sup>65</sup> Art.VII(1) of the N.Y. Convention: "The provisions of the present Convention shall not affect the validity of multilateral or bilateral agreement concerning the recognition and enforcement of arbitral awards entered into by Contracting States nor deprive any interested party of any right he may have to avail himself of an arbitral award in the manner and to the extent allowed by the law or the treaties of the country where such award is sought to be relied upon."

<sup>66</sup> *Berardi v. Clair* (unpublished), Cour d'Appel de Paris, 1980, reprinted in (1982) VII YBCA 319-21 cited in Park, *The Lex Loci Arbitri and international commercial arbitration*, (1984) 32 ICLQ 21 at 27.

<sup>67</sup> United States Court of Appeals for the Ninth Circuit 23 October 1989, reprinted in (1990) XV YBCA 605.

<sup>68</sup> *Ibid.* A similar conclusion was reached by the court in *Iran Aircraft Industries v. Avco Corp.*, 980 F.2d 141 (2d Cir.1992).

the language of Art.V(1)(e) suggested that the Convention only applies to national awards, the Court cited a passage of the Hoge Raad in the *SEEE case*: '...the strictures of Art. V do not come into effect unless and until the party against whom the award is invoked furnishes proof of the existence of one of the impediments specified under (a) to (e). The relationship between the award and the law of a particular country need only be examined in the framework of an investigation to be carried out following a plea that the impediments mentioned in Art.V(1) exist... in respect of which questions may arise which can be answered only with reference to the laws of a particular country'.<sup>69</sup> The Court held that a fair reading of the Convention suggests that it does not require that the award should be governed by the national law of the country of origin; Art.I of the Convention only mentions awards made in another Contracting State. Furthermore, Art.V(1)(d) indicates that only following a failure of the parties to agree on certain procedures, will the national law of the place of arbitration come into play.<sup>70</sup>

It appears that only in a few instances have courts enforced national awards in comparison to the great majority of foreign awards which are enforced according to the New York Convention and are considered to have the nationality of their country of origin. As to the applicability of the N.Y. Convention to national awards the rarity of decisions to that effect indicates a lack of interest by courts to depart from the main objective of the Convention which is to cover the recognition and enforcement of foreign awards i.e. made under a foreign national law.<sup>71</sup> This interpretation allows for setting aside procedures without which the award-losing party would be deprived of any remedy against an award tainted with major procedural faults in the country of

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<sup>69</sup> (1990) XV YBCA 605 at 609-10.

<sup>70</sup> *Ibid.* The reasoning of the court is open to question on a number of grounds. Firstly, the title of the Convention, as noted earlier, expressly refers to "foreign" awards meaning awards made under a foreign law. Secondly, the Court's reading suggests that grounds of refusal set out in paras. (a) to (e) only apply when the parties have not agreed on the procedure of the arbitration; this would mean that there could be situations where an award losing party would have no chance to challenge the award in the place of arbitration due to the fact that the arbitration was procedurally subject to a law other than that of the seat. This could not have been the intention of the drafters of the Convention.

<sup>71</sup> Van den Berg commenting on the position of national laws on the matter observes: This type of arbitration and award [delocalised] is rather exceptional in practice, as in almost all cases an arbitration is governed by the arbitration law of the place of arbitration (which is also the place of rendition of the award). Van den Berg, commentary in (1985) X YBCA at 347.

origin of the award. As noted in Ch. III, this is in line with the control scheme of the Convention which provides for control of arbitration both in the place arbitration and the country of enforcement.

### ICSID

It was noted that the Washington Convention regime is, to a large extent, self-contained. The exception is the matter of execution of awards which remains subject to the law of the place where the execution is sought. That law would decide whether the award should be treated as national or anational. Since ICSID arbitrations are procedurally detached from national laws, it seems more reasonable to consider ICSID awards as anational in the sense of being the outcome of an international arbitration. The duty of national courts to recognise and enforce such awards derives directly from a specific obligation of the ICSID Convention itself.<sup>72</sup> For example, in *LETCO v. Liberia*, a US District Court held that upon the submission of the certified copies of the award, the claimant was entitled to enforcement of the award i.e. the award should be treated "in the same manner and with the same force and effects as if it were a final judgment of" that court.<sup>73</sup> A question may, however, arise as to the execution of awards in non-contracting states of the ICSID. The answer would depend on the general position of the national laws as to the execution of ICSID awards and, in the case of awards rendered against the state party, also on their relevant laws on state immunity.

### Iran-US Claims Tribunal

In *Dallal v. Bank Mellat*, on the question of enforceability of the Iran-US Claims Tribunal awards, the Queen's Bench Division held that they are not enforceable under the New York Convention.<sup>74</sup> However, arguing that "[T]he jurisdiction and authority of the Tribunal ... was created by an international treaty between the United States and Iran, and was within the treaty making powers of the governments of these two

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<sup>72</sup> Art. 54(1).

<sup>73</sup> *Liberian Eastern Timber Corporation v. The Republic of Liberia* 650 F.Supp. 73 (S.D.N.Y. 1986) reprinted in (1987) 26 ILM 695 at 699.

<sup>74</sup> (1986) 2 WLR 745.

countries", the court considered the Tribunal's awards enforceable on the ground of *international comity*.<sup>75</sup>

As already noted, considerations of recognition and enforcement of the Iran-US Claims Tribunal awards become relevant, largely in relation to awards rendered in favour of Iranian arbitrating parties. The enforcement of such awards should be sought through the machinery provided by national laws for the enforcement of non-domestic awards. The issue of whether or not awards of the Tribunal are covered by the New York Convention has been mainly addressed in the literature in the context of the discussion of the applicability of the Convention to anational awards and has been determined in the affirmative.<sup>76</sup> The US Court in *Gould* also endorsed the applicability of the New York Convention to anational awards including those issued by the Tribunal.<sup>77</sup> The ruling is in conformity with the US Government's statement of interest which favours the enforcement of the Tribunal's awards in the United States within the framework of the New York Convention.<sup>78</sup>

From the above it would appear that, except for the awards of the treaty-based arbitrations, the enforceability of anational awards remains doubtful.

### 6.2.2 Public Policy

Public policy in the context of jurisdiction of arbitral tribunal was considered in Chapter II. It was noted that a distinction between domestic and international public policy is drawn by some commentators and has been taken up by some courts. Under

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<sup>75</sup> *Ibid.* at 764.

<sup>76</sup> See for example Lewis, *supra*, note 30 at 550-1; Toope, *supra*, note 2 at 119-20; Lake and Tucker, *supra*, note 30 at 811-2; Avanesian, *supra*, note 30 at 298-303.

<sup>77</sup> See above, notes 67-70 and accompanying text.

<sup>78</sup> "The current amount in the Security Account ... is less than the total face amount of outstanding claims by US nationals. It is therefore in the interest of the United States to insure that its obligations under the Accords and the claims process established at the Hague continue to be observed, in order to encourage Iran to fulfil its obligations under the Accords. A US judicial determination that awards of the Tribunal are enforceable in US courts would aid in effectuating that result.

Further, should Iran fail to carry out its obligation to replenish the Security Account in the future, the vast majority of private claims before the Tribunal will be dependent on judicial enforcement of Tribunal awards. The United States therefore has an interest in the establishment of an orderly procedure whereby awards of the Tribunal may be enforced pursuant to the Convention on the Recognition and Enforcement of Foreign Awards. Statement of Interest of the United States quoted in Lewis, *supra*, note 30 at note 13.

Public policy may be used as a ground to impede recognition and enforcement of the award.

### *New York Convention*

Art.V(2)(b) of the New York Convention provides that the competent courts of the enforcement jurisdiction have a discretion to refuse recognition and enforcement of awards on the ground of public policy.<sup>80</sup> Due to the nature of public policy, this ground can be subject to different interpretations in various jurisdictions. The distinction between domestic and international public policy has been adopted by those national laws in countries where the national policy favours the promotion international businesses. For example, courts in the United States differentiate between domestic and international public policy; foreign awards are denied enforcement only when such enforcement “would violate the forum state’s most basic notions of morality and justice”.<sup>81</sup> The US Courts have also emphasised the differences between the international public policy of the state and its foreign policy. In *National Oil Corporation (Libya) v. Libyan Sun Oil Company (US)* the US court for the District of Delaware did not accept the argument that enforcement of an award in favour of the Libyan Oil Company should be refused on the ground of public policy.<sup>82</sup> It distinguished public policy from foreign policy and argued that if the enforcement of the award is against the foreign policy of the United States, then the executive could block any transfer of funds to Libya through the Libyan Sanctions Regulations.<sup>83</sup>

The distinction between national and international public policy has not gained universal recognition though. In *COSID Inc. (US) v. Steel Authority of India Ltd.(SAIL)(India)* the parties had entered a contract whereby SAIL was to supply a certain amount of steel.<sup>84</sup> The contract contained an ICC arbitration clause. SAIL did not comply with its contractual obligations arguing force majeure resulting from a ban

<sup>80</sup> According to the Article: Recognition and enforcement of an arbitral award may also be refused if the competent authority in the country where recognition and enforcement is sought finds that:

(b) The recognition or enforcement of the award would be contrary to the public policy of that country.

<sup>81</sup> *Parsons & Whittemore Overseas v. RAKTA*, (1976) 1 YBCA, 205.

<sup>82</sup> 733 Federal Supplement (1990) at 800-822, reprinted in (1991) 16 YBCA 651 at 658-660.

<sup>83</sup> *Ibid.*

<sup>84</sup> Judgment of 13 July 1960, reprinted in (1986) 11 YBCA 502, at 505--6.

imposed by the Indian Government on the export of steel. COSID initiated arbitration proceedings and obtained an award for damages. It sought to enforce the award before the High Court of Delhi which refused to grant enforcement on the ground of public policy. The court considered the Government ban on the export of steel as a *force majeure* excusing SAIL from its contractual obligations.<sup>85</sup> It did not accept the objection that it could not “establish a new head of public policy” whenever there is a shortage of a commodity in India and thereby excuse Indian contractors from their obligations. The court reasoned that the implementation of Government export policies should be done in a way that “the country is not affected by unregulated exports of items essentially needed within the country”<sup>86</sup> On the distinction between domestic and international public policy, the court noted that under the relevant Indian legislation based on the New York Convention, there was no such distinction and it did not find itself under any obligation to even see “whether international public policy over-ride domestic public policy.”<sup>87</sup> It concluded that the expression “public policy” in the Indian Act and in Art.V(2)(b) of the New York Convention referred to the public policy of the country where enforcement is sought. Furthermore, the court noted that public policy might even be based on a circumstance which arose after the issuance of an award.<sup>88</sup>

Apart from specific provisions of the Convention specifically referring to public policy, there are public policy grounds of objective and subjective arbitrability which can be a basis for refusal of recognition of state contracts awards.<sup>89</sup> As noted in Ch. II the recognition of the *lex arbitri* of the relevance of the state party’s law as regards arbitrability of a state contract may undermine the arbitrability of the disputes arising from the contract.<sup>90</sup> An award resulting from arbitration of such dispute may be challengeable on the ground of lack of arbitrability of the subject matter. Furthermore, on the basis of the relevant provisions of the Convention, the lack of capacity of the

<sup>85</sup> On its jurisdiction to rule on the question of *force majeure*, the court held that since the terms of reference in the arbitration agreement were general, and not specific as to arbitrators power to rule on questions of law, the court had jurisdiction to rule on that question. *Ibid.* at 503-4.

<sup>86</sup> *Ibid.* at 507.

<sup>87</sup> *Ibid.*

<sup>88</sup> *Ibid.*

<sup>89</sup> Art. V (a) & (c) of the Convention.

<sup>90</sup> Ch. II, *supra*, 2.5.2.

from the contract.<sup>90</sup> An award resulting from arbitration of such dispute may be challengeable on the ground of lack of arbitrability of the subject matter. Furthermore, on the basis of the relevant provisions of the Convention, the lack of capacity of the state party may be a ground for refusal of recognition and enforcement. Such a situation is likely to happen when the arbitral tribunal's determination on the capacity of the party is based on laws other than that of the state party. Therefore, the public policy ground of the New York Convention can largely limit the scope of enforceability of state contracts awards.

Since Contracting State to the ICSID Convention are under a treaty obligation to enforce ICSID awards, in principle, there should not be any relevance for national public policies as ground for refusal of recognition and enforcement of such awards in the courts of Contracting States. Recognition and enforcement of ICSID awards in the courts of countries not party to the Convention will be subject to the law of those countries including their public policy limitations.

In principle, the recognition and enforcement of the Tribunal's awards and the applicability of national public policy limitations depend on the view of the courts of enforcing jurisdiction on the nature of the Tribunal and its awards.

### 6.2.3 Sovereign Immunity

The doctrine of sovereign immunity in relation to the adjudicative jurisdiction of courts and arbitral tribunals was dealt with in chapter II.<sup>91</sup> It was noted that under customary international law, in principle, states are immune from jurisdiction of foreign courts. The rule, in many jurisdictions, and in the view of many, in modern

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<sup>91</sup> Chapter II, *supra*, 2.5.3; In principle, there could be three possible approaches concerning the immunity of foreign states from jurisdiction of courts. (i) The view supporting the absolute immunity of states regardless of the nature and purpose of the underlying activity in question. This view was traditionally dominant. (ii) The restrictive doctrine of sovereign immunity which draws a distinction between commercial and governmental activities of states (*acta jure gestionis* and *acta jure imperii*) and grants immunity only as regards cases whereby a state is pursuing its governmental functions in the interests of the public. This type of immunity has been called functional immunity too as the function of the state in a given case could be a basis to determine whether it can be immune from claims resulting out of such cases. see Knierim, 'Sovereign immunity from judicial enforcement: The impact of the European Convention on State Immunity, (1973) 12 *Columb.J.Transnational L.*, 130 at 132. (iii) This view believes in no immunity for states in any case whatsoever. See Bernini, G. and Van den Berg, A., 'The problem of immunity from execution, in *Contemporary Problems in International Arbitration*, ed. J. Lew, London: Kluwer, 359.

customary law, is subject to certain exceptions including cases where the state consents to jurisdiction and where the dispute relates to a commercial activity. Furthermore, it was noted that an agreement by a state to submit to arbitration is considered as the state's *implied* waiver of immunity from jurisdiction of courts in proceeding concerning the conduct of that arbitration. The issue here is related to the immunity of states in the context of the recognition and enforcement of awards. One major question in this context is whether the implied waiver of a state by submitting to arbitration extends to the recognition and enforcement of the resulting arbitral award. A preliminary point is that the question of sovereign immunity and recognition and enforcement of arbitral awards has been addressed in two contexts. First, the narrower context where issues of immunity are considered exclusively in relation to international commercial arbitration. On the other hand, state immunity issues may be seen in the wider context of interstate relations. Delaume maintains that the problem of immunity from execution depends more on the "general rules of immunity prevailing in individual countries than considerations of transnational arbitration."<sup>92</sup>

First, the question is viewed within the framework of any general rules of international law concerning immunity of states from execution as implemented by national jurisdictions. In this sense, some jurisdictions consider an agreement to arbitrate by a state as an implied waiver from jurisdiction of courts in proceeding relating to both the conduct of the proceeding and the recognition and enforcement of the resulting award. There are also jurisdictions which, while recognising the implied waiver in relation to adjudicative jurisdiction, require an express waiver of immunity in matters relating to the recognition and enforcement of an arbitral award. Therefore, a clear distinction is made between, using the language of the House of Lords in *Alcom v. Republic of Colombia*, "the adjudicative jurisdiction" and "the enforcement jurisdiction" of courts.<sup>93</sup> The waiver of immunity could be with respect to one or both types.

The second view considers the question exclusively in the narrow context of

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<sup>92</sup> Delaume, in judicial decisions related to sovereign immunity and transnational arbitration, (1987) 2 ICSID Rev.-FILJ 403 at 412.

<sup>93</sup> [1984] 2 W.L.R. 750, 755.

international commercial arbitration in that it is argued that the arbitration agreement should be considered as a complete waiver of immunity:

Such an implied waiver is necessarily inferred from the *consensual* nature of arbitrations arising out of state contracts and is an inverse corollary to the basic premise that "consent to arbitration excludes all other remedies". If all other remedies are excluded, principles of justice and plain common sense require that nothing should be allowed to defeat the intention of the parties to resolve their differences through arbitration.<sup>94</sup>

This is in line with the transnationalist view of international commercial arbitration which seeks a maximum level of detachment of arbitration from national laws. Proponents of this view draw the line between jurisdiction, recognition and enforcement on the one hand and the execution of the awards on the other. It is argued that issues of immunity raised during recognition and enforcement procedures should be viewed as issues of immunity from jurisdiction; Only actual execution i.e. actual measures against property constitute a separate phase from arbitral proceedings. Relying on the principle of *pacta sunt servanda*, they argue that once a state has agreed to arbitration it has waived its immunity with respect to both jurisdiction and execution.<sup>95</sup>

The question of the immunity of a state from suit and execution are decided by the court seized of the matter. Regarding immunity from suit, it was seen that in many jurisdictions, the doctrine of sovereign immunity has moved from its absolute to a restrictive version. States are immune only with regard to their public (*acta jure imperii*) and not commercial activities (*acta jure gestionis*). Different tests are employed to draw a distinction between "immune" and "non-immune" transactions of states from suit. In connection with the question of immunity from execution, due to the fact that the underlying considerations may be different from those concerning the jurisdiction, national laws often follow a far more restrictive approach. On the rationale of this distinction, the Special Rapporteur to the ILC states:

Immunity is consistent not only with the dignity of a State but also with the very concept of Statehood. Without such immunity chaos may creep in ... States are now obliged to keep certain funds and assets abroad and to own properties in foreign lands for various representational and governmental functions in addition to their international trade or commercial activities.<sup>96</sup>

Fox argues that:

<sup>94</sup> Toope, *supra*, note 2 at 148-9 (footnote omitted).

<sup>95</sup> Bernini and Van den Berg, *supra*, note 91 at 363.

<sup>96</sup> Seventh Report, UN.doc.A/CN.4/388, para. 45.

The basis of the distinction is entirely practical. whereas a court proceeding leading to a judgment may be conducted in the absence of the foreign State and produces no immediate hindrance to that State's conduct of its affairs, execution of the judgment involves, in the last resort, the use of force against the foreign State by the seizure of assets. To effect that seizure, the forum court requires the assistance of the executive arm of the government and the friction such seizure is likely to cause in relations between the two countries has produced a rule of wide immunity from execution.<sup>97</sup>

There may be other grounds for a more restrictive view of immunity from execution such as the fear of reciprocity by the foreign states that is the exposure of the forum state to execution measures in the foreign state, and the fear that by allowing the execution of arbitral awards against foreign states and their property, the forum state may discourage foreign governments from keeping funds or investing within its territory.

There is no uniformity among national laws on the extent of state immunities from measures of execution. There are indeed major areas of differences among national laws.<sup>98</sup> It has been emphasised that about the only common rule in all legal systems in this area is that, "when immunity does not exist, only the commercial assets of the foreign State can be subject to execution."<sup>99</sup> This lack of uniformity among national laws on immunity of states from execution has contributed to the diversity of treatments that arbitral awards receive in various jurisdictions.<sup>100</sup> Below, the viewpoint

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<sup>97</sup> Fox, Enforcement jurisdiction, foreign state property and diplomatic immunity, (1985) 34 ICLQ 115 at 123.

<sup>98</sup> Delaume identifies three main difference areas which he refers to as (i) the commercial connection whereby the availability of the property subject to execution is restricted by a requirement that such property be used for the purposes of the transaction out of which the claim arises, (ii) the territorial connection which implies a sufficient connection between the transaction involved and the country of the forum, and finally (iii) the treaty connection that is the effect of treaty arrangement among States on jurisdictional and immunity rules. Delaume, *Judicial Decisions*, *supra*, note 92 at 414-422.

<sup>99</sup> *Ibid.* at 415

<sup>100</sup> The effect of this lack of uniformity of national laws on the question of recognition and enforcement of awards in general, and in particular in relation to the issue of immunity from execution can be seen in differing treatments that the *LIAMCO* award received in several jurisdiction. The Swiss Federal Court refused to recognise the award due to lack of forum connection. *Socialist People's Libyan Arab Jamahiriya v. Libyan-American Oil Co. (LIAMCO)*, 19 June 1980, (1981) 21 ILM 151. In France, after *LIAMCO* garnished banking and other accounts held by Libya and its entities, on the request of the public attorney, the court dissolved the garnishments arguing that they were in violation of Libya's immunity from execution. The court further appointed a committee to establish the purpose of the accounts. T.G.I. Paris, Mar.5, 1979, *Procureur de la République v. Société LIAMCO*, 106 *Journal du droit international* 857 (1979), cited in Delaume, *Enforcement of State Contract Awards: Jurisdictional Pitfalls and Remedies*, (1993) 8 ICSID Rev.-FILJ 29 at 32-33. In the US, the Act of State doctrine was argued for the court not to enforce the award. *Libyan American Oil Co., v. Socialist People's Libyan Arab Jamahiriya*, 482 F. Supp. 1175 (D.D.C. 1980). In Sweden the award was granted recognition and enforcement. See *Libyan American Oil Company v. Socialist People's Arab Republic of Libya*, Svea Court of Appeals, 18 June 1980, reprinted in 62 ILR 225.

of a number of legal systems on the matter is considered.

In the UK immunity matters are covered by the 1978 State Immunity Act which has embraced the restrictive theory of sovereign immunity and the waiver doctrine.<sup>101</sup> According to Section 9 when a state has agreed in writing to submit to arbitration, it is not immune from the jurisdiction of the UK courts in proceedings which relate to that arbitration. The territorial scope of the waiver contained in this section is unclear. The question is whether the Section applies only to arbitrations held in the UK or does it have a universal application.<sup>102</sup> Furthermore, the text of the Act does not clearly make the distinction between immunity from jurisdiction and immunity from execution.<sup>103</sup> That matter, together with a number of other major issues concerning immunity and execution of awards, were addressed by the House of Lords in *Alcom v. Republic of Colombia*.<sup>104</sup> Alcom obtained a default judgment against the Government of Colombia and sought execution against Colombian Embassy bank accounts in London. The exception contained in Section 13(4) of the SIA only allows execution against the property "which is for the time being in use or intended for use for commercial purposes" (italics supplied). The determining factor regarding to commercial character and purpose of the state's property would be the certificate issued by the head of the state's diplomatic mission in the United Kingdom.<sup>105</sup> The Colombian Ambassador issued such a certificate indicating that the purpose of the funds was to help pay the day-to-day running of the Embassy, the account, therefore, being public. The first instance court set aside the Alcom's request.<sup>106</sup> This decision was reversed by the Court of Appeal which argued that the purpose of the money in the bank could never be to

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<sup>101</sup> For a brief study of the historical background and provisions of the Act in relation to the immunity of states from jurisdiction see chapter II at note 170.

<sup>102</sup> Fox is in favour of a narrow interpretation of the Section in this respect that is the Section is applicable only to arbitrations taking place in the UK. Fox, *States and the Undertaking to Arbitrate*, (1988) 37 ICLQ, 1 at 14; The US FSIA amendment has clearly pointed to a broad territorial scope of the waiver.

<sup>103</sup> The case law prior to 1978 shows that courts in the United Kingdom draw a distinction between immunity from jurisdiction and immunity from execution and in general did not order forcible execution against a foreign state. See in Fox, *supra*, note 97 at 124 and the cases cited therein.

<sup>104</sup> [1983] 3WLR 906; [1984] 2WLR. 750, H.L. reversing the decision of the Court of Appeal : commentary in Fox, *Enforcement jurisdiction, foreign state property and diplomatic immunity*, *supra*, note 97 at 115.

<sup>105</sup> Section 13 (5).

<sup>106</sup> See the ruling of the first instance court in the decision of the Court of Appeal, [1983] 3 WLR 906 at 908.

The decision was appealed. The House of Lords reversing the Appeal Court's decision stated the view of English law on execution against the property of foreign states. It examined different provisions of the 1978 SIA against its background, cases decided prior to the enactment of the Act, and international law. It held that in the context of execution measures against diplomatic missions' property the mere fact that the funds may partially be used to buy goods and services is not sufficient to apply the exception to *foreign state general immunity*.<sup>109</sup> The decision emphasised the distinction between immunity from suit and immunity from execution (enforcement).<sup>110</sup> Therefore, having applied the "purposive" test and having found the embassy account to be a *mixed* one, the House of Lords reversed the Appeal Court's decision and granted immunity from execution.<sup>111</sup> Therefore, according to the Act, in general, the property of a state is immune against measures of execution unless is used for commercial purposes or consent to such measures. The Act does not require a link between the property against which measures of execution are sought and the claim. Property of separate entities of states, which are not immune from jurisdiction of the courts, is not immune from measures of execution.<sup>112</sup> Even, when the entity is immune from jurisdiction but chooses to submit to such jurisdiction, its commercial property, as defined by section 13(4), is not immune from measures of execution.<sup>113</sup> According to section 14(4) of SIA the property of central banks and other monetary authority of foreign states is immune from process unless such entities consent to such process.<sup>114</sup>

In the context of the extent of the implied waiver, a number of new legislations have

<sup>109</sup> [1984] 2WLR. 750 at 758-60.

<sup>110</sup> "... section 13(2) granted a general immunity to the enforcement jurisdiction of the United Kingdom courts to be the property of a foreign sovereign state save for the exception created by section 13(4); that in the context of the Act taken as a whole, and against the background of its subject matter, public international law, the words of exception in that subsection were not apt to describe the credit balance standing in the current account kept with a commercial banker for the purpose of meeting the expenditure incurred in the day-to-day running of a foreign embassy; that, accordingly, unless it could be shown by the judgment creditor who was seeking to attach the balance by garnishee proceedings (for the onus lay on him) that the bank account was designated by the foreign State (save for de minimis exceptions) for being drawn upon to meet liabilities incurred in commercial transactions, section 13(4) could not apply, and that in the circumstances the plaintiffs had failed to discharge that onus. *Ibid.* at 751.

<sup>111</sup> *Ibid.* at 759.

<sup>112</sup> See section 14(1).

<sup>113</sup> Section 14(3).

<sup>114</sup> Section 14(4)

set aside the distinction between immunity from jurisdiction and immunity from enforcement. The US Foreign Sovereign Immunities Act (FSIA) as amended in 1988 and the Australian 1985 Foreign States Immunities Act are two examples of such legislations which have precisely addressed the question.

The US FSIA, as noted earlier in this work, reflects the acceptance of the restrictive theory of immunity with respect to the jurisdiction of courts.<sup>115</sup> "Under international law states are not immune from the jurisdiction of foreign courts in so far as their *commercial activities* are concerned, and their *commercial property may be levied upon* for the satisfaction of judgments rendered against them in connection with their *commercial activities*" (italics supplied).<sup>116</sup> The commercial character of the activity is determined by reference to its *nature* and not to its *purpose*.<sup>117</sup> Following the 1988 Amendment, the FSIA deals with state immunity and enforcement of arbitral agreements and awards in a specific manner. Section 1605 (a)(6) provides that a state is not immune from jurisdiction of courts in an action to enforce an arbitration agreement made by the State or to confirm an award made pursuant to such an agreement to arbitrate, "if (A) the arbitration takes place or is intended to take place in the United States, (B) the agreement or award is or may be governed by a treaty or other international agreement in force for the United States calling for the recognition and enforcement of arbitral awards, (C) the underlying claim, save for the agreement to arbitrate, could have been brought in a United States court under this section or section 1607, or (D) paragraph (1) of this subsection is otherwise applicable." According to this Section, the implied waiver extends to the recognition and enforcement of awards. Furthermore, the rule of clause (B) has widened the territorial scope of the implied waiver from immunity. According to this rule, an agreement by a state to arbitration outside the United States would be considered as an implied waiver of immunity from the jurisdiction of the US courts provided that the United States has some treaty arrangement calling for the recognition and enforcement of arbitral awards. Therefore, the clause is applicable to conventions such as the New York Convention,

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<sup>115</sup> Chapter II, *supra*, 2.5.4.

<sup>116</sup> Section 1602 FSIA.

<sup>117</sup> Section 1603(d).

the ICSID Convention and US bilateral treaties.<sup>118</sup>

As to the immunity of States against measures of execution the Act provides that , the property in the United States of a foreign State in principle is immune from execution subject to a number of exceptions.<sup>119</sup> According to Art.1610(a)(6) the property of a foreign state *used for a commercial activity* is not immune from execution if “the judgment is based on an order confirming an arbitral award rendered against the foreign state, provided that attachment in aid of execution, or execution, would not be inconsistent with any provision in the arbitral agreement.” In *Birch Shipping Corp. v. Embassy of the United Republic of Tanzania*, on the question of the immunity of the mixed bank account of the Embassy under the FSIA, the court considered the *nature* of the transaction carried out through the bank account was relevant and not its purpose.<sup>120</sup> It further took the view that, the Act did not require the account to be used exclusively for commercial activity to be considered as non immune.<sup>121</sup>

The FSIA draws a distinction between property of State and that of a State agency or a State instrumentality.<sup>122</sup> In the case of States, only their property that is “used for commercial activity in the United States” can be subjected to measures of execution.<sup>123</sup> Whereas with regard to State entities “any property in the United States” of such entities, as long as it is not immune from jurisdiction in the same claim, may be

<sup>118</sup> Prior to the 1988 Amendment, on the question of territorial scope of the implied waiver the US courts followed divergent views. Some courts considered that the waiver extended to cases where the seat of arbitration was located in the United States. See *Verlinden B.V. v. Central Bank of Nigeria*, 488 F.Supp. 1284 (S.D.N.Y. 1980); *Ohntrup v. Firearms Centre Inc.*, 516 F.Supp.1281 (E.D.Pa 1981) *Chicago Bridge v. Islamic Republic Of Iran*, 506 F.Supp.981. On the other hand, the court in *Ipitrad* held that an agreement providing for the ICC arbitration in Paris by Nigeria constituted under FSIA a waiver of immunity that could not be unilaterally revoked. Submission to arbitration was considered as a waiver as long as it related to an arbitration located in the United States or a country party to the New York Convention. *Ipitrad International v. Federal Republic of Nigeria*, (1978) 465 F.Supp. 824(DDC), reprinted in (1978) 17 ILM 1395. A similar conclusion was reached by the court in *Libyan American Oil Company v. Socialist People's Libyan Arab Jamahiriya*, 482 F.Supp.1175(D.D.C.1980), reprinted in 62 ILR 220.

<sup>119</sup> Section 1609; exceptions in Section 1610 and Section 1611.

<sup>120</sup> 507 F.Supp.311 (D.D.C.1980), for a commentary of the case see Troobof, *Foreign Sovereign Immunity: Emerging consensus of principles*, (1986) 200 RCADI 245 at 367; A different view was taken by an Italian court which has held: “Whatever an embassy account was put to mix uses, for both sovereign and non-sovereign purposes, the concept of immunity should prevail. Only if a non-sovereign use of specific funds clearly emerged from the evidence could those be subjected to execution. *Banamar-Capizzi v.Embassy of the Popular Democratic Republic of Algeria* (1989) Court Cassation, 87 ILR 56 at 66-1; see also *MK v. State Secretary of Justice*, (1986), The Netherlands Council of State, 94 ILR 357.

<sup>121</sup> *Ibid.*

<sup>122</sup> Section 1610.

<sup>123</sup> *Ibid.* subsection (a).

subjected to measures of execution.<sup>124</sup> Section 1611 sets out certain types of property which are *absolutely* immune from execution, including property of “a foreign central bank or monetary authority held for its own account”, and property that “is used, or is intended to be used in connection with a military activity”, and is of a “military character” or is “under the control of a military authority or defence agency”.

The Australian legislation of state immunity has taken a more liberal attitude concerning the scope of the waiver of immunity. According to the Australian Foreign States Immunities Act of 1985, states are in general immune from jurisdiction subject to a number of exceptions including ‘state’s consent’ and ‘commercial transactions’.<sup>125</sup> Section 11(3) sets out a non-exhaustive list of commercial activities.<sup>126</sup> The Act specifically deals with the question of arbitration agreement as an implied waiver of immunity. It has set aside the distinction between immunity from jurisdiction on the one hand and recognition and enforcement on the other. According to Section 17(2) when a foreign State has consented to submit to arbitration, the State is not immune in a proceeding concerning the recognition as binding for any purpose, or for the enforcement, of an award made pursuant to the arbitration, *wherever the award was made*” (italic supplied). The latter part of the subsection is the endorsement by the Act of the universal scope of the implied waiver that a State by agreement to arbitration located anywhere in the world, waives its immunity in proceedings relating to the enforcement of the arbitration agreement and award in Australia. As regards measures of execution against property of states, there is a rule of immunity of states subject to, among others, ‘express waiver’ by the state or ‘commercial property’.<sup>127</sup>

The lack of uniformity of national laws on the question of immunity is observed also in states without legislation on sovereign immunity. This could be due to divergent attitudes on the scope of the implied waiver and also specific jurisdictional requirements of those national laws. Switzerland and France are two examples of states

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<sup>124</sup> *Ibid.* subsection (b).

<sup>125</sup> April 1, 1986 reprinted in (1986) 25 ILM 715. Section 9 deals with general immunity from jurisdiction: Sections.10-21 inclusive set out the exceptions to the general rule.

<sup>126</sup> “In this section, “commercial transaction” means a commercial, trading, business, professional or industrial or like transaction into which the foreign State has entered or a like activity in which the State has engaged and, without limiting the generality of the foregoing, includes- ...”

<sup>127</sup> Sections.30-35.

without legislation on sovereign immunity. Swiss law has adopted the restrictive theory of sovereign immunity. There is no distinction between immunity from jurisdiction and immunity from enforcement:

The settled jurisprudence of the Federal Tribunal was that immunity from enforcement was simply the consequence of jurisdictional immunity and where a foreign State did not enjoy jurisdictional immunity it was equally not entitled to immunity from enforcement unless the measures of enforcement concerned assets allocated for the performance of acts of sovereignty.<sup>128</sup>

Therefore, an agreement to arbitrate is considered as a waiver of immunity from the jurisdiction of courts in proceedings relating to enforcement and execution of the resulting award. On the distinction between *acta jure imperii* and *acta jure gestionis*, Swiss courts have based their decisions on "the nature of the act concerned and not its purpose".<sup>129</sup> Furthermore, there is a requirement that there should be a territorial connection between the claim and Switzerland. Therefore, failing such a link the Swiss courts grant immunity no matter the nature of the activity.<sup>130</sup>

The immunity of a foreign State from execution is a rule in France and can be set aside only by way of exception.<sup>131</sup> Further clarification of the French law position on the question of execution of awards against states can be seen in *Eurodif*.<sup>132</sup> The case involved complex cooperation arrangements involving the Government of Iran and the Iranian Atomic Energy Organisation on one side and Eurodif a French corporation and the French Atomic Energy Commission (FCA) and its subsidiary Uranium Research and Study Corporation (CEA) on the other. Iran lent CEA \$1 billion and its repayment

<sup>128</sup> *Arab Republic of Egypt v. Cinetelevision International*, Swiss Federal Tribunal, 20 July 1979, (1984) 65 ILR 424. For commentary of Swiss law see Lalive, J.F., 'Swiss law and practice in relation to measures of execution against the property of a foreign state', (1979) 10 NYIL 153.

<sup>129</sup> *Italian Republic, Italian Ministry of Transport and Italian State Railways v. Beta Holding Sa and Another.*, Swiss Federal Tribunal, 22 June 1966, 65 ILR 394 at 395.

<sup>130</sup> The Swiss Federal Court did not consider the Swiss location of arbitration as a sufficient link between the forum and the case: "It was unnecessary to determine whether Libya had acted *jure gestionis* or, by the arbitration clause in the concessions, had waived its immunity, since Swiss law did not permit proceedings against a foreign State unless there was a close connection between the subject matter and Switzerland. In the present case, although the arbitration had taken place in Geneva, it had only done so, because the Sole Arbitrator had so decided. That decision did not create a sufficient legal relationship with Switzerland where, as was the case here, the subject matter at issue in the arbitration had no connection with Switzerland." *Libyan American Oil Company v. Socialist People's Libyan Arab Jamahiriya* (Swiss Proceeding), 62 ILR, 228 at 229.

<sup>131</sup> See Delaume, *Judicial Decisions Related to Sovereign Immunity and Transnational Arbitration*, *supra*, note 92 at 411.

<sup>132</sup> *EURODIF Corporation v. Islamic Republic of Iran*, Cour de Cassation 14 March 1984, translation in (1984) 23 ILM 1062.

was guaranteed by the French Government. After the Islamic Revolution, Iran chose to discontinue the cooperation agreement. Eurodif initiated arbitration proceedings for the breach of contract and at the same time sought to attach Iranian funds (\$1 billion) in French courts.<sup>133</sup> The first instance court granted the attachments. On appeal, the Court of Appeal of Paris reversed that decision and granted immunity on the basis of the public "nature of the funds".<sup>134</sup> It did not take the inquiry as far as the "nature of the activity" in question. Eurodif appealed.<sup>135</sup> The *Cour de Cassation* held that it is not enough to look only at the nature of the funds. The underlying activity of the State is also material in two respects. That it has also to be "commercial" and that the fund must be used for that "activity".<sup>136</sup> Therefore, the position in French law, according to the *Cour de Cassation* in this case can be summed up as follows: in principle States and their property are immune from measures of execution in relation to their *jure imperii* acts. The exception relates to cases of economic activities of a private law character conducted by states. To draw the distinction, the inquiry would focus on the "nature of the funds" as well as the "nature of the activity" on which the claim is based. Furthermore, there must be also a link between the funds and the activity forming the basis of the claim.

French courts have made a distinction between the property of a State and that of state entities with regard to measures of execution. In *Société Nationale Algérienne de Transport et de Commercialisation de Hydrocarbures (Sonatrach) v. Migeon* it was held that, being distinct from the foreign state, assets of a state entity could be subjected to measures of execution by all debtors of that entity, of whatever type, provided that the assets formed part of a body of funds allocated for a principal activity.<sup>137</sup>

The European Convention of 1972 on the Immunity of States adopts the general

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<sup>133</sup> *Ibid.* at 1063.

<sup>134</sup> *Ibid.* at 1064-1068.

<sup>135</sup> *Ibid.*

<sup>136</sup> *Ibid.* at 1069.

<sup>137</sup> France, Court of Cassation 10 October 1985, English Translation in 77 ILR 525; Also in *Société Air Zaire v. Gauthier and Van Impe*, French Court of Appeal, 77 ILR 510.

immunity approach as far as the execution measures against states are concerned.<sup>138</sup> According to Art.23 of the Convention no measures of execution may be implemented against a Contracting State without its written consent. However, Contracting States may make a declaration thereby maintaining their national laws and limitation therein applicable.<sup>139</sup> Therefore States making such a declaration may apply their restrictive principles of immunity subject to other provisions of the Convention including Art.26 which allows execution against property of States only as far as it has been solely used for the commercial activity which forms the basis of the claim.

The ILC Draft adopted the doctrine of restrictive sovereign immunity with regards to states and their property.<sup>140</sup> There is no rule specifically dealing with the question of arbitration agreement as a waiver of immunity. Therefore, the matter is dealt with in the general rules of immunity. According to the Draft Articles, the immunity of States against measures of execution is the rule subject to exceptions of 'State's express consent'<sup>141</sup> and 'commercial property'.<sup>142</sup> The commercial character of the property against which measures of execution are sought is determined by reference to the *purpose* of its use. Furthermore, there should be a link between the property and the claim which is the object of the proceeding or with the agency or instrumentality against which the proceeding was directed.<sup>143</sup>

The ICSID Convention makes it mandatory for the court designated by each Contracting State to recognise an ICSID award upon production of a copy of the

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<sup>138</sup> The Text of the Convention 11 ILM 470; Commentary see Sinclair, I., *The European Convention on State Immunity*, (1973) 22 ICLQ 254.

<sup>139</sup> Art.24 of the Convention.

<sup>140</sup> Draft Arts.5, 6 and 10.

<sup>141</sup> According to Art.18(1)(a)&(b):No measures of constraint, such as attachment, arrest and execution, against the property of a State may be taken in connection with a proceeding before a court of another state unless and except to the extent that:

(a) the State has *expressly consented to the taking of such measures* as indicated:

(i) by international agreement

(ii) by an arbitration agreement or in a written contract; or

(iii) by a declaration before the court or by a written communication after a dispute between the parties has arisen;

(b)the State has allocated and earmarked property for the satisfaction of the claim which is the object of that proceeding (*italics supplied*).

<sup>142</sup> Art.18(1)(c).

<sup>143</sup> *Ibid.*

award certified by the Secretary-General of the ICSID.<sup>144</sup> The Convention distinguishes between recognition and enforcement on the one hand and execution of awards on the other. This distinction was confirmed by the Court of Appeal of Paris in *Benvenuti et Bonfan v. Congo*.<sup>145</sup> It held that Article 54 of the Convention provides a simplified exequatur procedure which does not constitute an act of execution but only an act preliminary to execution. It then concluded that the court below could therefore not, without exceeding its authority interfere in the second phase where the question of sovereign immunity becomes relevant.<sup>146</sup>

The Convention, as seen, despite the claim of providing a self-contained system of arbitration independent of national laws, as regards execution of awards provides for the sole application of the laws in force in the State where execution is sought.<sup>147</sup> In *LETCO v. Liberia* the US Court for the Southern District of New York held that in the context of the US FSIA, the assets of Liberia against which measures of execution were sought constituted tax revenues for the support of *governmental* functions and, therefore were immune from measures of execution.<sup>148</sup> However, the Court accepted the possibility of execution against properties used for commercial activities listed in Sec.1610 of FSIA.<sup>149</sup>

In another enforcement proceeding, the Paris Court of Appeal failed to distinguish between the recognition of ICSID awards which was subject to the procedure provided by the Convention and execution of the award which was governed by French law.<sup>150</sup> The appellate court reversed a recognition order of a lower court on the ground that it would violate the immunity of Senegal from execution and was therefore contrary to public policy of France.<sup>151</sup> This decision was later quashed by the *Court of Cassation*

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<sup>144</sup> Art.54 of the Convention.

<sup>145</sup> Judgment of 26 June 1981, *Cour d'Appel*, Paris, reported in VII YBCA (1982) 159.

<sup>146</sup> *Ibid.* at 161.

<sup>147</sup> Art.54(3) of the Convention.

<sup>148</sup> 89 ILR 355.

<sup>149</sup> *Ibid.* at 357-60.

<sup>150</sup> *Senegal v. Seutin* (as Liquidator of the West African Industrial Concrete Company (SOABI), (1990) 29 ILM 1341; (1990) 5 ICSID Rev.-FILJ, 135-138 with note by E. Gaillard at 69-72.

<sup>151</sup> See Art. 1502(5) of the New French Code of Civil Procedure which reads in Part: "An appeal against a decision granting recognition or enforcement may be brought only in the following cases: If the recognition or enforcement is contrary to international public policy.

which emphasised that recognition (exequatur) did not constitute a measure of execution and therefore, did not raise issues of immunity from execution.<sup>152</sup>

From the above study, it would appear that national laws have largely treated the immunity of states from enforcement in the light of interstate considerations and not those of international commercial arbitration. Thus, as a rule states and their property remain immune against the measure of execution. There is no uniformity among national laws on the scope of the exceptions to this rule of immunity:

“There is no need to stress the fact that domestic rules of immunity are not uniform and that, even when those rules favour the restrictive doctrine of immunity, their implementation does not always yield concordant results. Under the circumstances, forum shopping may have a significant impact upon the type of support, or the lack of it, that may be expected from domestic courts in the context of proceedings relating to transnational adjudicatory jurisdiction is such that it offers many opportunities for judicial jockeying.<sup>153</sup>

Proponents of international commercial arbitration criticise this state of law as not satisfactory as it provides a wide range of immunities for states and their assets.<sup>154</sup> They suggest that the distinction between *acta jure imperii* and *acta jure gestionis* and also the one between immunity from jurisdiction and immunity from enforcement should be set aside.<sup>155</sup> Furthermore, it is argued that the territorial link which in the context of arbitration limits the extent of the waiver must be removed. The result of the above changes would be that once a State agrees to arbitration, it will be subjected to the supervisory role of all courts and its property and assets could be subjected to measures of execution regardless of their nature, purpose and locale. This solution could be too costly for both the State party to arbitration and the country where the execution is sought. The suggested changes are aimed at raising the level of effectiveness of international commercial arbitration. They ignore the wider considerations of states which are the basis for the limitations imposed by international law and national laws on the availability of measures of enforcement against states and their property. As to the attempts at harmonisation, the direction of theoretical

<sup>152</sup> *SOABI (Seutin) v. Senegal*, Court of Cassation, 11 June 1991, (1991) 30 ILM 1167, Introductory note by G.R. Delaume.

<sup>153</sup> Delaume, *Enforcement of State Contract Awards: Jurisdictional Pitfalls and Remedies*, (1993) 8 ICSID Rev.-FILJ 29.

<sup>154</sup> Bernini, G. and Van den Berg, J. ‘The enforcement of arbitral awards against a state: the problem of immunity from execution in Lew, J. *Contemporary Problems in International Arbitration*, *supra*, note 91 at 359

<sup>155</sup> *Ibid.*

discussions, and the state of law indicates that the uniformity of rules concerning immunity still remains a remote possibility.<sup>156</sup> However some national laws which have taken steps towards implementation of measures proposed by the advocates of international commercial arbitration.

#### 6.2.4 Act of State

The issue of the Act of State doctrine and jurisdiction of arbitral tribunals was considered earlier.<sup>157</sup> It was noted that according to the doctrine "courts of one country will not sit in judgment on the acts of the government of another done within its own territory."<sup>158</sup> Here, the question is whether the doctrine could be of any relevance to recognition, enforcement and execution of arbitral awards against states. At least one court has answered the question in the affirmative. The Court in *Libyan American Oil Co v. Socialist People's Libyan Arab Jamahiriya*<sup>159</sup> relying on Art.V(2)(a) of the New York convention which is a ground for the refusal of recognition and enforcement for lack of subject-matter arbitrability refused to grant recognition and enforcement arguing that the Act of State doctrine barred the court from looking at the validity of Libyan nationalisation acts. The Court reasoned that it could not have ordered arbitration since it would require the Court to rule on the validity of the Libyan nationalisation law which was an act of state.<sup>160</sup> This decision has attracted a great deal of criticism.<sup>161</sup> The Court appear to have confused notions of arbitrability and Act of State. To see whether or not an act of nationalisation is arbitrable<sup>162</sup> or is within the scope of the arbitration

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<sup>156</sup> Delaume has stated:

"This of course, is hardly a satisfactory state of affairs. If transnational arbitration involving states is to be made appealing to both state and private claimants, both parties ought to be given greater certainty regarding the positive results that they can expect from this method of dispute resolution. Such is no immediate assurance that efforts towards the harmonisation of immunity rules will yield tangible results other than compromises on the wording of provisions that leave many concrete issues unanswered. For the time being, interested parties operating in the context of an imperfect world must reconcile themselves to imperfect solutions." Delaume, *supra*, note 92 at 422-3.

<sup>157</sup> See chapter II, *supra*.

<sup>158</sup> *Oetjen v. Central Leather*, [1918] 246U.S. 297.

<sup>159</sup> 482 F. Supp.1175(D.D.C.1980), reprinted in 62 ILR 220.

<sup>160</sup> *Ibid.* at 223.

<sup>161</sup> Toope, *supra*, note 2 at 151-157.

<sup>162</sup> New York Convention, Art. V(ii)(a).

agreement<sup>163</sup>, does not require the examination of the validity of the act by the court hence the court was not barred by the Act of State doctrine. In the event, the parties reached a settlement and the decision of the Federal District Court was vacated without opinion at the request of the US Government.<sup>164</sup> The above case, however, shows that Act of State and similar national law doctrines may impede the process of recognition and enforcement of awards. This could be particularly the case in the countries where the courts retain some residual power to open a case on its merits at the enforcement stage. Although the possibility of this has been greatly limited by the New York Convention, the possibility may exist under more-favourable right provision of Art.VII, and also in countries not party to the New York Convention.

### 6.3 Conclusion

From the above study, it would appear that, in principle, the question of recognition and enforcement of arbitral awards has been addressed within the context of arbitration of private disputes arising from international commercial transactions. National laws in line with their policy of promotion of stability of international contractual relations through, among others, effective arbitration, have provided for relatively simple procedures for recognition and enforcement of arbitral awards. With regard to the enforcement of state contracts awards, however, the existing limitations to the recognition and enforcement awards, including those relating to the arbitrability, public policy, sovereign immunity and Act of State, is indicative of the restrictive attitude of national laws towards enforcement of awards which may implicate important national public policy matters. As a result of such limitations, there remains very limited scope for effective resolution of state contracts disputes through international commercial arbitration.

By comparison, awards of treaty-based arbitrations stand a better chance of being enforced as the limitations relating to anational awards, public policy, arbitrability and Act of State are not generally available against the enforcement of these awards. Furthermore, state parties to the underlying treaties are under an international

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<sup>163</sup> *Ibid.*, Art. V(i)(c).

<sup>164</sup> (1981) 684 F.2d 1032 (DCCA)(USA)

obligation to enforce such awards. For example, in the case of ICSID awards, the Contracting States' commitment to enforce such awards is based on a treaty breach of which would give rise to the international responsibility of the state in breach. However, even in the case of ICSID, the fact that execution of awards are subject to the stringent rules of national laws, reveals that from the point of view of Contracting States, in the case of a conflict, considerations of national policies prevail over those of effective arbitration of a particular investment dispute.

## Chapter VII

### Summary and Conclusions

Since late nineteenth century the world has witnessed an increasingly active participation by states in the economic life of their respective nations.<sup>1</sup> The actual degree of such participation depends on the type of the economy - in a controlled or a mixed economy, the state obviously plays a more active role than in a market-economy. This role tends to be greater in developing countries where, in the pursuit of economic self-determination and development, states often take charge of the restructuring of the economy.<sup>2</sup> It is usually in this context that states enter contracts with foreign nationals. As the most common form of such contracts, contemporary foreign direct investment agreements between states and multinational corporations contain an inner conflict between public (sovereign) and private interests.<sup>3</sup> Within the context of such agreements, while foreign investors pursue the global policy of profit maximisation, the state is often concerned with the pursuit of national economic objectives.<sup>4</sup> The main issue regarding such contracts has been how to reconcile these conflicting private and public interests.

The conflict is normally between the flexibility of contractual arrangements required by the public interest and stability of contract as the demand of private interest. Naturally, the question of the applicable substantive law becomes of central importance. The demand of public interest is normally met by the host state's law according to which the state enjoys prerogatives of modification and termination of the contract where the interests of the public so require.<sup>5</sup> Private investors do not find this acceptable. Often changes made to the contract regime by the state entail a fall in the level of expected profits. It is mainly for this reason that the private investor's position with regard to the question of the legal regime of the contract is influenced by the desire to avoid the exercise of such prerogatives. Consequently, contractual forms have been utilised to promote a further degree of stability in the regime of state contracts. More specifically, the inclusion of choice of law clauses providing for the

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<sup>1</sup> Ch. I, *supra*, 1.2.1.

<sup>2</sup> *Ibid.*

<sup>3</sup> *Ibid.*, notes 37-44 and accompanying texts.

<sup>4</sup> *Ibid.*

<sup>5</sup> *Ibid.*, 1.2.2.

application of laws other than that of the state party or the application of the state law combined with other standards, stabilisation and arbitration clauses have been pursued by private parties.<sup>6</sup> The main quest therefore is the resolution of the conflict between sovereignty of the state and sanctity of the contract.

The practice of *ad hoc* arbitral tribunals dealing with state contracts is characterised by a strong movement in favour of the delocalisation- often internationalisation- of the procedure.<sup>7</sup> Based on the sovereign immunity considerations, a number of arbitral tribunals delocalised the procedure of arbitration of state contracts.<sup>8</sup> As a result of this, such tribunals were in a stronger position to distance the contract from the coverage of municipal laws including that of the state party. According to these tribunals, in the light of the nature of such contracts, and the inclusion of certain contract terms, the parties intended to submit them to a delocalised choice of substantive law namely to international law or to a third legal order.<sup>9</sup> The result of this line of reasoning is that, through an agreement with a private party, a state can irrevocably fetter its sovereign powers with respect to the subject matter of that agreement. Typical of this group of awards is *Texaco* which considered the sovereign status of one party as a ground for the delocalisation of the procedure and regarded the contractual clauses as the basis for the internationalisation of the substantive law.<sup>10</sup> According to the award, the nationalisation of concessionaire rights under an agreement which included a stabilisation clause was unlawful in international law. Furthermore, it considered restitution in kind as the appropriate remedy of international law. Therefore, in the view of such awards sanctity of contracts prevailed over sovereignty.

Various theories of delocalisation of state contracts, particularly the internationalisation of the *Texaco* kind, clearly gave priority to the protection of the interests of the private party. According to these theories, states' participation in international economic activities amounts to their submission to the principle of

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<sup>6</sup> See Ch.IV, *supra*, 4.3.3.

<sup>7</sup> *Ibid.*, 4.3.

<sup>8</sup> E.g. *Saudi Arabia v. Arabian American Oil Company (Aramco)*, Award of 23 August 1958, 27 ILR 117; Also see, *supra* at 104-105.

<sup>9</sup> *Ibid.*

<sup>10</sup> *Texaco overseas Petroleum Company and California Asiatic Oil Company (Texaco) v. The Libyan Arab Republic*, Award of 1977, 53 ILR 389.

equality of the partners in international trade. They have been rather indifferent to the developments in national laws and international law which, in the light of the state function and the involvement of public interest, maintain the inequality of the parties in transactions between states and private parties.<sup>11</sup> More specifically, in relation to government contracts, the protective approach of national laws towards public interest is reflected in their recognition of the powers of the state to, on public interests grounds, modify or terminate its contracts.<sup>12</sup> The new role of the state has also influenced international law where, as a rule, immunity is maintained for those transactions of the state which, in the light of both their purpose and nature, are not characterised as *jure gestionis*.<sup>13</sup>

The application of various theories of delocalisation almost invariably result in the state contracts being subjected to the principle of *pacta sunt servanda*. It is for this reason that such delocalisation of state contracts has been regarded as their privatisation:

From the very start, the most forceful and vocal elements in support of the trend saw in it a means for removing state contracts from the domain of public law, which is generally sensitive to the heterogeneity of public and private interests, and applying to them instead principles appropriate for contracts between homogeneous parties. These principles were found, in the main, in the international law of treaties, a body of law intended to govern formal instruments concluded between public collective entities, deemed equal (and homogeneous) in the eyes of the law, and thus in fact- stricter- in the sense of allowing fewer exceptions to general rules and imposing fewer "public order" requirements- than even the law of private contracts in developed national legal systems. In this manner, the qualitative differences between public and private interests at stake on each side were assumed away, and the "internationalisation" of state contracts led, paradoxically, to their "privatisation." In much of the doctrine and in the limited practice extant, the trend points to pervasive limitation of the host state's sovereign authority within its own territory.<sup>14</sup>

Therefore, one may reasonably argue that the theories of delocalisation advanced by arbitral tribunals and also advocated by some Western jurists were clearly biased; they were essentially pro-investors.<sup>15</sup> The internationalised contract theory in effect leads to the imposition of limitations on sovereign authority of the host state within its

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<sup>11</sup> See Ch.I, *supra*, 1.2.2.

<sup>12</sup> See Ch.I, *supra*, 1.2.2.1.

<sup>13</sup> *Ibid.* 1.2.2.2.

<sup>14</sup> Fatouros, A., International law and internationalised contract, (1980) 74 AJIL 134 at 140-1.

<sup>15</sup> On this point, Professor Audit observes: "However varied these reasoning are, it appears that their effect is the same on the whole; to justify taking the contract away from the exclusive ascendancy of the laws of the state and affirm the rule of *pacta sunt servanda*. It could be inferred from this fact that their authors are guided by an incoercible prejudice." Audit, B., *Transnational Arbitration and State Contracts: Finding and prospects*, 1988 at 103.

territory. It adversely affects the process of decolonisation, namely that of the control over natural resources, which has now been recognised by international law:

The transfer of control over natural resources to the state in order that such resources may be used to further the developmental goals of the poorer countries is an aim of the international community. This aim has been articulated in a series of General Assembly resolutions, in the claims made for a new international economic order, and in the reports of non-governmental bodies. Many of these claims have been based on the idea that now that the role of subservience has ended as a result of decolonisation, the third world is entitled to distributive justice in the form of just prices for commodities, transfer of technology and permanent control over natural resources. Some scholars have argued that the infusion of the notion of distributive justice into international law has given rise to a new branch of that law relating to human welfare and development. The growth and acceptance of this branch of the law would be inconsistent with the existence of an "international contract law" which is aimed at the preservation of an order established during the colonial era.<sup>16</sup>

The internationalisation of the substantive law of state contracts was based on the delocalisation (rather internationalisation) of the procedure of arbitration. It is noted that, in the light of the developments in national laws, which consider an agreement by a state to submit to arbitration as a waiver of its immunity with regard to the related courts proceedings, sovereign immunity considerations as the basis of such internationalisation of the procedure of arbitration is highly questionable. Furthermore, the enforceability of state contracts in international law, as it stands, is also doubtful. Historically, the development of international law regarding foreign investment has been within the framework of protection of aliens and their property, as such its rules are not primarily geared to the regulation of contracts.<sup>17</sup> This is also consonant with the provisions of Art.42 (1) of the ICSID Convention which provides for the applicability of the state party's law together with international law.<sup>18</sup>

In recent practice and writings, more emphasis has been placed on the sovereignty element of investment agreements. For one thing, more support has been expressed in favour of the application of the law of the host state.<sup>19</sup> In this sense, the legality of a wide range of regulatory measures taken by the state party are examined within the framework of the law of the state. Unlike *Texaco*, which viewed international law as containing a set of contract rules, the recent awards are more in line with the view

<sup>16</sup> Sornarajah, M., *The myth of international contract law*. (1981) 15 JWTL 187 at 193-4.

<sup>17</sup> See ch.IV, *supra*, esp. Conclusions.

<sup>18</sup> For the discussion of Art.42(1) and the related cases see Ch.IV, *supra*, notes 179-198 and accompanying texts.

<sup>19</sup> *Ibid.*, Conclusions.

which considers the relevance of international law to investment agreements rather limited to the protection of foreign property (investment rights of the foreign private party). In this context, it is noted that the strict rules of international law which considered any taking of foreign-owned property as a wrongful act were a product of the time when such takings were normally motivated by the group interests of the ruling elites in the host country.<sup>20</sup> Such takings, in general, had no connections to any overall national economic policy.<sup>21</sup> Takings by the state in public interest, is the result of the assumption of the new role by the state with regard to the national economy and public welfare.<sup>22</sup> These takings especially occur in the area of natural resources where states, particularly those in the developing world, asserted the principle of sovereignty over natural resources.<sup>23</sup> The response of international law to this development was the affirmation of the rights of states, on the ground of public interest, to nationalise foreign-owned property.<sup>24</sup> On the question of whether this sovereign right of the state can be fettered by contractual stabilisation clauses, the prevailing view of arbitral tribunals and specialist writings has been in the negative.<sup>25</sup> Indeed, it may well be argued that the recent arbitral practice has increasingly given weight to the protection of public interest. As the Tribunal in *Amoco Finance* noted:

In no system of law are private interests permitted to prevail over duly established public interest, making impossible actions required for the public good. Rather private parties who contract with a government are only entitled to fair compensation when measures of public policy are implemented at the expense of their contract rights. No justification exists for a different treatment of foreign private interests.<sup>26</sup>

However, an overall conclusion requires an examination of remedies in arbitration of state contracts. The study of this subject reveals that compensation for a taking is the main remedy ordered by arbitral tribunals. The controversy between the opposing sides is on the applicability and the scope of the international law standard of compensation for taking of aliens' property. In broader terms, the issue is related to a

<sup>20</sup> Sornarajah, *International Law of Foreign Investment*, Cambridge: Grotius 1994, 253.

<sup>21</sup> See Ch.I, *supra*, 1.2.1.

<sup>22</sup> *Ibid.*

<sup>23</sup> See Ch.I, *supra*.

<sup>24</sup> *Ibid.* at 17.

<sup>25</sup> See Ch.IV, *supra*, at 152-7.

<sup>26</sup> (1987) 15 Iran-US CTR 242-3.

conflict between private property rights and the state; whether property has a social function and if so what is the extent of it. In principle, the right of individuals to own property is recognised by all legal systems.<sup>27</sup> However, such systems also introduce limits to private property rights on the ground of the interests of the society. In the course of last century, national laws have attached more importance to the social function of property.<sup>28</sup> Even in the market economies, the social function of property is recognised.<sup>29</sup> In the developing countries, where many states have taken on the task of the restructuring of the economy, strong emphasis has been placed on the limitation on private ownership in favour of public ownership in major areas of economic activities.

With regard to the limits imposed by the state on the ownership of property by foreigners, as noted, international law recognises the right of the state to nationalise foreign-owned property rights including contract rights subject, among others, to the payment of compensation.<sup>30</sup> It is the standard of compensation which remains controversial. The viability of bilateral investment treaties, lump sum and claims settlement agreements as source of an international law standard of compensation is highly doubtful.<sup>31</sup> Furthermore, given the lack of consensus as to their binding effects, the UN General Assembly resolutions, including their provisions concerning the standard of compensation, do not appear as firm authority on the standard of compensation.<sup>32</sup> In this state of affairs, one might argue arbitral awards as the source of the rule of law on the question.<sup>33</sup>

Issues of the standard of protection of foreign investment and that of compensation reflect conflicting political interests at the international level. This conflict is, in turn, reflected in the conflicting views expressed at the international level on the concept and function of property in international community. The applicability of the standard of full compensation is advanced by the western capital-exporting countries as it best

<sup>27</sup>Higgins, *The Taking of property by the State: Recent Developments in International Law*, (1982) 176 RCADI 259.

<sup>28</sup>*Ibid.*

<sup>29</sup>E.g. the Fifth Amendment of the U.S. Constitution. See Ch. I, *supra*, under 1.2.2.1.

<sup>30</sup>See Ch. V, *supra*, 5.4.

<sup>31</sup>*Ibid.*, notes 115-128 and accompanying texts.

<sup>32</sup>*Ibid.*, notes 129-138 and accompanying texts.

<sup>33</sup>*Ibid.* at 213.

serves the protection of the private property rights of their nationals according to a standard enshrined in their politico-economic system i.e. the liberal market-economy system. This standard is challenged, *inter alia*, on the ground that the social function of property now has been recognised by many states as a basis for the limits to private property rights. In the case of the developing countries the conflict is also related to their position concerning the underlying setting of the rules which reflect the structural inequalities in the world economic order largely left from the colonial past.<sup>34</sup> The traditional notions of compensation are viewed by the developing countries as those belonging to an old inequitable economic order.

There is no doubt that in an area where there is no settled rule of international law, the value of compromise is highly appreciated. In this context Dolzer maintains:

“...since international law necessarily develops within the larger framework of international political alliances and factions, when political situations involve various conflicting interests, legal solutions tend to consist of compromises that harmonise these interests to the best extent possible in the given set of political circumstances.”<sup>35</sup>

Certainly standards designed to cope with the demands emerging from one side of the conflict may not offer themselves as a compromise solution acceptable as a rule of international law. Therefore, an appropriate solution on the question of the standard of compensation should to some degree move away from the full formula in order to place it in line with the compromise between the conflicting interests at the international level on the rule of compensation. The question here is how close solutions of the arbitral tribunals are to a potential compromise solution at the international level. The insistence by arbitral tribunals on the application of the full standard of compensation place them rather away from a compromise between the competing positions regarding the standard of compensation and place them in line with the position taken by the capital exporting countries. The lowering of the final amount of compensation by relying on certain circumstantial mitigating factors including equitable considerations and a case-by-case choice and application of valuation methods cannot persuasively be argued as creating a well-defined standard of appropriate compensation. Indeed, arbitral awards on compensation are very much case-specific. Such treatment by

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<sup>34</sup> See ch.I, *supra* at 5.

<sup>35</sup> Dolzer, R., *New Foundations of the Law of Expropriation of Alien Property*, (1984) 75 AJIL 553 at 573.

arbitral tribunals of the matter may however be construed as their recognition of the unworkability of the full standard in all cases. Here a more fundamental question arises as to whether arbitration of state contracts could be considered as an authoritative decision-making process at all. The treatment of this question requires the study of other types of arbitrations including arbitrations rooted in national laws- international commercial arbitration- and treaty-based arbitrations and their effects on state contracts disputes settlement.

The evolution of national laws in popular seats of arbitration in the West points to a trend in favour of a less interventionist approach to international commercial arbitration whereby national legal sovereignty is compromised in favour of arbitral autonomy.<sup>36</sup> More specifically, the enforceability of arbitral agreements and awards, the separability doctrine, arbitrator's wide powers to rule on jurisdictional challenges and limited courts supervision are increasingly recognised by national laws.<sup>37</sup> It was noted that the substantive rules applied and the remedies ordered by arbitral tribunals and their compatibility with the public interest requirement, are the main determinants of the attitude of the state party on a particular type of dispute settlement. In the context of arbitrations subject to national laws, the protection of public interest element of the contract may be primarily achieved through such choice of law rules which recognise the state party's law as the applicable substantive law of contract or as applicable foreign mandatory rules.<sup>38</sup>

On the specific effects of these developments on state contracts disputes settlement, it was noted that the liberal view of national laws on arbitration in a number of Western industrial countries has resulted in an expansive approach to the scope of arbitration.<sup>39</sup> This scope may be broadened to a further extent when the limitation of arbitrability is decided according to a transnational public policy- even to an extent beyond the agreement of the parties.<sup>40</sup> This may lead to the assumption of jurisdiction in relation to matters which otherwise would be inarbitrable on grounds such as lack of capacity of

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<sup>36</sup> See, in general, ch.II, *supra*.

<sup>37</sup> *Ibid.* at 2.3 & 2.4.

<sup>38</sup> See ch.IV, *supra* at 4.2.1.1.

<sup>39</sup> See ch.II, *supra* at 2.5.

<sup>40</sup> See Ch.II, *supra*, 2.5.1.1.

the state party or regulatory aspect of the contract or some limiting effects of sovereign immunity or Act of State.<sup>41</sup> The broadening of the scope of arbitrability, in particular with respect to regulatory matters, may not attract so many objections in the developed countries where national legal systems, in line with the overall interests of the relevant communities, allow for a greater scope for arbitration.<sup>42</sup> This may however be contrary to the restrictive view of developing states, on arbitration of matters of public interests.<sup>43</sup>

Parallel to the expansion of the scope of arbitrable matters in international commercial arbitration, a trend is noticed in favour of the relaxation or elimination of external control mechanisms in the place of arbitration.<sup>44</sup> This further enhances the powers of arbitral tribunals and the possibility of rendition of awards in excess of powers which may not be remedied at the enforcement forum.<sup>45</sup> The difficulties involved with the enforcement of awards against states, and the fact that such awards are often used as a basis for further negotiation on a final settlement on the amount of compensation, would mean that such awards often do not reach the stage of enforcement and therefore the excess of power by arbitral tribunal may never be

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<sup>41</sup> *Ibid.*, 2.5.4 and 2.5.5.

<sup>42</sup> This kind of extension of arbitrability has been criticised even by some of the strong supporters of international commercial arbitration as being detrimental to the interests of the developing countries. "The extension of arbitral jurisdiction to encompass regulatory disputes that attend commercial transactions, however, amounts-by definition- to an excess of arbitral authority. National statutes, linked to fundamental interests and which, for example, prohibit corporate bribery, securities fraud, or monopolistic commercial conduct, fall outside contractual privileges and transcend mere commercial needs. Such regulatory frameworks are meant to act as essential constraints upon commercial activity for reasons of public welfare. Admittedly, the public welfare is defined by national jurisdictions; these regulatory frameworks nonetheless are a manifestation of the sovereign's will and can be compromised only by the sovereign. The expansion of adjudicatory authority disturbs the balance between vital national interests and the need for arbitral autonomy. It makes arbitration workable between similarly positioned, Western, developed countries, but tends to exclude developing world countries from international commerce because arbitration on these terms becomes too great an infringement upon the sovereignty of national policy." Carbonneau, *The Remaking of Arbitration: Design and Destiny*. In *Lex Mercatoria and Arbitration*, Edited by T.E. Carbonneau I, New York: Transnational Juris Publication/Dobbs Ferry 1990, 17

<sup>43</sup> *Ibid.*

<sup>44</sup> See ch.III, *supra*, 3.3.2.

<sup>45</sup> Generally, this lack of control, it is argued by the proponents of transnational arbitration, can be remedied in the place of enforcement since the need for enforcement of the award is the main connecting factor between a transnational arbitration and national laws. It was noted however that the appropriate level of control required by international conventions is achieved when the primary control at the place of arbitration assures "secondary enforcers [at the place of enforcement] that an award ordering the transfer of wealth abroad has been appropriately policed in the primary jurisdiction where it was created." See Reisman, M.W., *Systems of Control in International Adjudication and Arbitration*, Durham/London: Duke University Press, 116-7. See also Ch.III, *supra*, 101-4.

remedied. Certainly, this is not compatible with the state's procedural expectations.<sup>46</sup>

As a result of the delocalisation of the procedure in the place of arbitration there will be a greater potential for arbitral substantive autonomy whereby an arbitral tribunal will be empowered to decide cases according to national standards, a new law merchant—the *lex mercatoria*.<sup>47</sup> This in effect would mean a movement towards the total privatisation of procedure and substance through transnationalisation of arbitration.<sup>48</sup> This transnationalisation of arbitration should be viewed within the context of a wider theory of transnationalisation of the legal regime of international economic transactions. This theory challenges the classical view of private international law and its function:

“...[this] school sees private international law as an evolving body of substantive commercial law. Its proponents argue that private international law has been transformed from a choice of law system to a set of material rules that regulate transnational dealings and activities. The transformations in the global community and the economic interdependence of states have rendered the concept of territoriality obsolete. Moreover, although private international law— in its substantive sense— gains its origins in national legal systems it is a regime of legal governance that eventually transcends parochial municipal boundaries. It regulates “delocalised” international contracts and arbitral proceedings and evidences the emergence of a new “lex mercatoria”. The universalist school also contends that neither municipal law nor public international law provides a sufficient juridical basis for transnational economic relationships (particularly those between states and foreign corporations). Subjecting transnational commercial parties to domestic requirements and the territorial authority of municipal systems is both inappropriate and undesirable. A new legal order needs to be fashioned that takes new realities into account. According to Lord McNair, “the complexity of the modern world... compels the abandonment of any facile dichotomy of law into national law and public international law.” Schmitthoff echoes the same sentiment: “This is the area in which a transnational law of international trade has developed and can be further evolved. This law is essentially founded on a parallelism of action in the various national legal systems, in an area which... the sovereign national state is not essentially interested.”<sup>49</sup>

<sup>46</sup> For an indication of the procedural expectations of states see the ICSID regime of procedural remedies, *supra*, 3.4.1.

<sup>47</sup> See in Ch. IV, *supra*, 4.3.

<sup>48</sup> *Ibid.*

<sup>49</sup> Carbonneau, *supra*, note 42 at 7-8 (footnotes omitted).

The major criticism of this theory is the inadequacy of its underlying assumptions.<sup>50</sup> To claim that sovereign legal systems are disinterested in the regulation of transnational economic transactions and the settlement of disputes thereof is a crude misrepresentation of the facts for both developing and developed countries take an active interest in these areas. The basis of the enforceability of international contracts and arbitration agreements remains national laws. Various mandatory provisions of national laws concerning international contracts and arbitration evidence the involvement of such national interests. The basis of such mandatory laws is the recognition of the primacy of national interest in areas where the particular territorial interests are so paramount that they may not be compromised. Based on the principle of reciprocity in international law, national legal systems may extend this recognition even to important public policy provisions of foreign laws. This is best reflected in the regime of the New York Convention which has, on a reciprocal basis, incorporated the recognition of national public policy requirements with regard to the enforceability of both arbitration agreements and awards.<sup>51</sup> Furthermore, the divergent views expressed by national laws on various aspects of economic transactions undermine the assumption by the theory of the existence of "parallelism of action" among national legal systems.<sup>52</sup>

The values and objectives sought by various participants in transnational economic activities are not limited to those of the international business community i.e. universal market-economy values. Many of the values sought by these participants are closely linked to the cultural, economic and political structure of the territorial communities.

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<sup>50</sup> This problem with this kind of universalist natural law approach, in general, has been described by Morison as follows: "The ethical rationalism, upon which natural law theory is based, operates by ignoring the possibility of a conflict of objectives between the theorist and the addressee of his theory. When the theorist tells a person that some action - for present purposes, some demand on or decision of a person or body exercising some degree of authority and control in the trans-national arena - is ultimately favoured by reason, there is necessarily a suggestion that such a decision would favour what the addressee supports as well as what the theorist supports. But at the same time the theorist confuses the addressee's mind by concealing the fact that reasoning can only justify itself in terms of some source of norms, that source being an objective or complex of objectives which will only appeal to the addressee if he happens to share it (italics supplied)." Morison, W.L., *The Schools Revisited*, in *The Structure and Process of International Law: essays in legal philosophy, doctrine and theory*, The Hague/Lancaster: Nijhoff 1983 130 at 136-137.

<sup>51</sup> Reisman, *supra*, note 45 at 139.

<sup>52</sup> See *supra*, 176-178.

National public policy, in a sense, is the legal manifestation of such territorial values.<sup>53</sup> In international law it is a matter of controversy whether the rules are policy oriented or not.<sup>54</sup>

The *lex mercatoria* is claimed to be connected to a transnational public policy which, as presented by arbitral tribunals, is designed to serve the "universal notions of contractual morality" and the "fundamental interests of international trade" in that the promotion of stability in contractual relations is a primary concern.<sup>55</sup> Thus it is in the nature of a transnational trade policy.<sup>56</sup> Transnational public policy assumes the universal virtues of the market-economy for all the territorial communities and the world as a whole. This notion has been challenged, among others, by those who seek the promotion of an international law of the welfare state which focuses on the promotion and protection of the interests of the economically weaker members of the international community. The adequacy of the *lex mercatoria* to address the demands of diverse national public policies is highly questionable:

Modern law is increasingly a complex and nuanced social instrument designed to achieve a wide range of quite detailed social and economic objectives. It is changed frequently, for our period is marked by radical changes in *context* and *goal* and equally rapid adjustments in legal instruments. The older legal methods, refurbished as *lex mercatoria*, were cogent in their contexts but are not in this setting. If they are applied in a modern context, their effect will be simply to ignore and exclude prescribed national policies that would otherwise be relevant.<sup>57</sup>

World development following a market economy pattern is achieved through a kind of mechanical or undifferentiated economic growth in terms of a continued increase in the level of production.<sup>58</sup> The maintenance of this sustained economic growth is the underlying objective and is a requirement of this system. It has been argued that such

<sup>53</sup> See *supra*, 176-178.

<sup>54</sup> See in general Higgins, R., *Problems and Process: International Law and how we use it*, Oxford: Clarendon Press 1994; also McDougal and Reisman, a Policy-oriented International Law, *supra*, note 29 The ICJ in *South West Africa cases* held: We are not unmindful of, nor are we insensible to, various considerations of a non-judicial character, social, humanitarian and other ... but these are matters for the political rather than for the legal arena. They cannot be allowed to deflect us from our duty or reaching a conclusion strictly on the basis of what we believe to be the correct legal view. ICJ Rep.(1962) 466 (joint diss. op.) by Judges Fitzmaurice and Spender quoted in Higgins, *ibid.* at 4.

<sup>55</sup> See ch. II, *supra* a, 2.5.1.1.

<sup>56</sup> Lalive, P., Transnational (or truly international) public policy and international commercial arbitration, In *Comparative arbitration practice and public policy in arbitration*, Edited by P. Sanders, Kluwer 1987, 313.

<sup>57</sup> Reisman, *supra*, note 45 at 135.

<sup>58</sup> Gregg, A., From Undifferentiated to Organic Growth in Mesarovic, M. and Pestel, E., *Mankind at a turning point: The Second Report to the Club of Rome*, Hutchinson of London 1975.

a growth is not necessarily beneficial to the various members of the international community and also to the mankind at large. Various reasons have been argued for a reform in the world economic order in favour of a more policy-oriented system requiring the furtherance of a kind of organic growth, which, in turn, would require a redistribution of labour.<sup>59</sup> Such grounds at a global level include the development of underdeveloped regions, the conservation of resources, and the protection of the environment. The above goals have been pursued by various interest groups in the international community within the framework of international law. In this sense, law assumes an active role in the ordering of the international society. The prime example of such efforts, which is directly relevant to the study of state contracts, is the movement for a new international economic order which has been sought by the developing states in various international *fora*. The legal instruments of the NIEO are all influenced by a kind of global thinking in favour of a more equitable economic order.<sup>60</sup> It is in the light of the recognition of these differing, and sometimes conflicting, policy objectives that a multilateral approach to the development of law relating to transnational matters appears to be more appropriate. Within the context of international law, the existence of diverse value systems and the need to take account of them have been emphasised:

First let it be said with no uncertain voice that the subjection of the totality of international relations in the greatly enlarged international community to a universal international law does not at all mean that international law is or could be a monolithic, much less a Eurocentric monolithic, system. On the contrary, as more and more aspects of international law reach down through the State to corporations to other legal entities and to individuals, so international law has more and more to take into account and allow for differences of municipal law, differences of legal tradition, and differences of culture; for these differences are facts with which the international system has to deal; and it will fail adequately to do so in so far as it proves insufficiently flexible to allow for adjustment to the different situations.<sup>61</sup>

The content of the law made by transnational arbitration may be influenced by

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<sup>59</sup> *Ibid.*

<sup>60</sup> See ch.I, *supra* at 4.

<sup>61</sup> Jennings, *Universal International law in a Multicultural World*, In *Liber Amicorum for Rt.Hon. Lord Wilberforce*, Edited by Bos, M. and I. Brownlie 39, Oxford:Clarendon Press 198 at 48. It is on this premise that he questions the validity of the natural law approaches of international law and the like: "It seems to this writer, indeed, that at the present juncture in the development of the international legal system it may be more important to stress the imperative need to develop international law to comprehend within itself the rich diversity of cultures, civilisations and legal traditions, than to concentrate on what might be called the 'common law of mankind approach' which sees importance in those general notions which, so long as they are stated in sufficiently general terms, are undoubtedly but hardly surprisingly to be found in all systems." *Ibid.* at 49.

various interests of the law-makers i.e. arbitrators who largely come from the legal profession. For one thing, the development of law by lawyers may follow the pattern of their specialisation which, in turn, is related to their professional interests. In the area of consumer laws, for example, a study has shown that "lawyers' interests and values affect the way they represent clients and that reforming laws, such as new laws favouring consumer interests, need to have incentives built into them to encourage lawyers to use them and advise their clients of them."<sup>62</sup> International commercial arbitration is manned predominantly by Western private lawyers whose professional knowledge and interests are often geared to the protection of private interests.<sup>63</sup> On the role of lawyers group's interests on the adoption of liberal legislation on arbitration, it has been maintained:

The abdication of responsibility for providing some system of control over international commercial arbitration occurring within their jurisdiction by a number of major industrial states appears to have resulted from pressure from small segment of the bar anxious to attract more arbitral business. By some mysterious process of juridical transubstantiation, the interests of these small groups have been portrayed as the interests of the polity as a whole. What that they are asking is the privilege of resolving disputes without any control over anything that may be done.<sup>64</sup>

Private interest is only one of the factors which may influence the development of law in a particular direction. There are other factors such as national, cultural, and group interests which may influence the decision of a transnational academic/law-maker and thereby the content of the law.<sup>65</sup> The lack of fair representation in the transnational law-making process, in effect could lead to a centre-periphery situation where a 'universal' law is made by a Western core of transnational elites or, as it has otherwise been described, by a private club of initiates.<sup>66</sup> In any case, as will be seen below, the law-making ability of transnational arbitration is very doubtful as there is

<sup>62</sup>The study was done by Macaulay quoted in Cotterrel, R., *The Sociology of Law: An Introduction*, London/Dublin/Edinburgh: Butterworths 1992. at 33.

<sup>63</sup>Morison maintains that the "fact remains that the practitioner's immediate objectives is to serve private interests." *supra*, note 50 at 132. For the international bar which are the main players of the scene of international commercial arbitration, either as arbitrators or counsel, a privatised arbitration would mean more freedom of action, more income.

<sup>64</sup>Reisman, *supra*, note 23 at 132.

<sup>65</sup>"The anxieties mentioned ... concerning pressures from private and national interests upon the legal academic with transnational concerns are only examples of external pressures upon him conducive to narrow or 'brand' thinking of some kind. External pressures range over the whole scope of cultural, class, and interest group factors bearing upon the academic." Morison, *supra*, note 50 at 133.

<sup>66</sup>The position is described by Audit, *supra*, note 5 at 81.

always the problem of conflicting rulings by different arbitrators on the same issue, and the question of which one takes precedence as 'law'. Besides, the confidential nature of awards, and the lack of reasons in many awards, it is difficult to find out what the prevailing view of the arbitrators on a particular point is. In fact, unlike the claim of its advocate as to its law-making value, it appears that transnational arbitration in this sense is largely an *equitable* business dispute settlement procedure.<sup>67</sup>

The claim of insufficiency of national and international law to provide a judicial basis for contracts between governments and private parties is also unwarranted and insensitive to the interests of territorial communities. The claim is based on the assimilation of state contracts to ordinary commercial contracts in which the interests of both parties are of a private nature. The public interest element of state contracts provides a strong tie between the contract and the territorial community that the state party represents. The importance of such a tie to the community is the basis of its judicial competence to regulate the contract and the settlement of disputes arising therefrom. Indeed, the transnationalisation of contracts is most strongly challenged when it is related to state contracts. It has been maintained that it "promotes mainly the commercial interests of the transnational business community" and that "it may satisfy rather self-serving aims which favour powerful companies, and it offers a grave defect particularly in cases where States are involved."<sup>68</sup>

Another fundamental flaw of the transnationalisation theory is related to its view of the authority of transnational law and transnational arbitration. Party autonomy cannot be argued convincingly as the mandate of an arbitrator is limited to the relationship between the two parties and cannot affect others. It is exactly for this reason that with respect to the enforcement of arbitration agreement and awards, transnational

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<sup>67</sup> Professor Glossner describes *lex mercatoria* as "the doctrine of generally existing rules accepted by the laws of all civilised nations which ... seeks equitable solutions for transnational transactions." Glossner, *The Influence of the International Chamber of Commerce on Modern Arbitration in 60 Years of ICC Arbitration: A Look to the Future*, 399.

<sup>68</sup> Paasivirta, E., *Participation of States in International Contracts, and Arbitral Settlement of Disputes*, Helsinki: Lakimiesliiton Kustannus (Finish Lawyers' Publishing Company) 1990. 315.

arbitration would need the support of national laws.<sup>69</sup> National laws' support of arbitration is conditioned to the fulfilment by arbitral tribunals of the relevant public policy requirements.<sup>70</sup>

From the above account of the inadequacy of a number of its underlying assumptions, it would appear that the theory of transnationalisation of the law of transnational economic activities, is fundamentally flawed. More appropriately, the theory may be considered as the international business community policy statement regarding the regulation of international economic transactions and the settlement of disputes arising therefrom. It largely ignores the considerations of the inequality of the parties to and the involvement of public interest in state contracts and the need for the protection of such interest which has been recognised by municipal and international law. Toope, in his study of ICC arbitration, as one type of arbitration largely based on the idea of the *lex mercatoria*, concludes that such arbitration is not suitable for state contracts disputes as:

The needs and ideals of governments do not fit within this neat schema, especially when issues of public policy and sovereignty are involved as in the case of the expropriation of foreign owned property. The goals of promoting international commerce and of encouraging the development of a *lex mercatoria* will be of little importance to a developing state seeking to appropriate the assets of a foreign oil company that it believes has been gaining excessive profits for many years. ICC arbitration will probably not be capable of sufficient sensitivity and subtlety in such cases, for it has been shaped to service the "international community of merchants." It was not designed to cope with the intense cultural and ideological differences that may emerge in the course of politicised disputes involving governments.<sup>71</sup>

It should be borne in mind that the scope of transnational arbitration in principle depends on the balance between arbitral autonomy and the limits of national public policies of the place of arbitration and the enforcement forum. It is noted that,

<sup>69</sup> On the place of international commercial arbitration in relation to national and international law, Professor Reisman maintains: "International commercial arbitration is a form of private international dispute resolution based on a network of public international agreements. It is neither self-sustaining nor autonomous nor is it driven by some sort of inherent logic which can persuade states to support it. Quite the contrary. In the absence of reciprocal commitments and effective controls, there is no reason why a government will allow its public powers to be used to seize the property of one of its nationals and to send it abroad, merely because a private and thoroughly nonofficial actor called an arbitrator has presumed to order it. That so-called arbitrator cannot even promise reciprocity for that state's nationals when they may have property claims against others, for arbitrators have no enforcement powers of their own. Without the assurance of enforcement by a national court in whose territory an award debtor's property is located, international commercial arbitration simply will not work. Reisman, *supra*, note 45 at 139.

<sup>70</sup> See Ch. VI, *supra*, 6.2.2.

<sup>71</sup> Toope, *Mixed International Arbitration: Studies in Arbitration between States and Private Persons*, Cambridge: Grotius 1990, 216 (footnote omitted).

following their underlying economic interest, national laws in a number of Western countries, through the relaxation of their public policy in favour of arbitral autonomy, have created some scope for transnational arbitration.<sup>72</sup>

From the above, it would appear that the procedural and substantive determinations of arbitrations which, as a result of internationalisation by *ad hoc* tribunals or transnationalisation by national laws, are delocalised largely ignore the inequality of the parties in state contracts as the basis for the flexibility of contractual relations. Consequently, there will be a strong likelihood of the exclusion by arbitral of sovereign discretions of the state party through delocalisation of the substantive law or by order of such remedies that effectively cancel the result of the exercise of such discretions. In general, the above policy of internationalisation of the regulation of international contracts and arbitrations is compatible with the overall interests of the free market economies. More specifically, the favourable policy adopted by Western countries towards arbitral autonomy is clearly in line with the overall interests of these countries as the compromise of legal sovereignty in favour of arbitral autonomy is done in return for a piece of the lucrative market of arbitration. This policy of internationalisation of the regulation of international contracts and arbitration, in the way which has been pursued by the international business community and endorsed by some national laws, certainly is not compatible with the interests of developing countries as parties to state contracts.

It should be noted, however, that the fact that an arbitration is delocalised does not necessarily mean that it is inappropriate for the settlement of state contracts disputes. It is rather the basis and rationale for the delocalisation, and the effects of such delocalisation on the control of the procedure and substantive standards applied by the tribunal which should be taken as the basis for any appraisal. The central question therefore is to what extent a given type of arbitration takes into account the considerations relating to the inequality of the parties and the involvement of public interest as a basis for recognition of the state's extra contractual powers. It is in this

<sup>72</sup> As noted, a number of national laws have relaxed their public policy limitations in the case of international commercial arbitration in that they have created some degree of transnationalisation in the place of arbitration. There are also a small number of jurisdictions, namely Switzerland and Belgium which have limited their public policy control of arbitration to a minimal level whereby a higher degree of transnationalisation has become possible. See, *supra*, chapter III, 3.3.2.2.

sense that the study of treaty-based arbitrations becomes relevant.

As compared to those of *ad hoc* and international commercial arbitration, the procedural aspects of those arbitrations which have been designed to specifically deal with state contracts disputes are more compatible with the needs of public interest. For instance, the ICSID Convention provides for a delocalised regime of arbitration which is relatively more sensitive to the particular needs of arbitrations between states and private parties.

As noted, the control regime of ICSID tries to ensure arbitral tribunals' adherence to their jurisdictional limits and the proper conduct of proceedings.<sup>73</sup> More importantly, its choice of law provisions provide, in the absence of a choice by the parties, for the applicability of the state law together with international law.<sup>74</sup> The limitations which these provisions impose on arbitral tribunals have been emphasised by ICSID *ad hoc* committees.<sup>75</sup> The fact that, despite its international character, the ICSID regime subjects the execution of awards to sovereign immunity rules applicable at the place of enforcement indicates that, in the case of conflict, from the point of view of Contracting States, the relevant overall interstate considerations may prevail over the considerations relating to arbitration of a particular investment dispute.<sup>76</sup> Overall interstate considerations, in particular political factors, often have a greater influence on the procedure and the outcome of international claims tribunals established following a bilateral or a multilateral treaty with the aim of settling existing disputes.<sup>77</sup> For example, the examination of various aspects of the Iran-United States Claims Tribunal including its imbalanced regime of procedural remedies<sup>78</sup>, the lack of adherence by the Tribunal to the strict rule of law<sup>79</sup> and its exceptional enforcement

<sup>73</sup> See Ch.III, *supra*, 3.4.1.

<sup>74</sup> See Ch. IV, *supra*, notes 179-198 and accompanying texts.

<sup>75</sup> See decisions of the ICSID *ad hoc* Committees in *Klöckner v. Cameroon*, Annulment decision of May 3 1986, (1986) 1 ICSID Rev-FILJ. 89; *Amco Asia v. Indonesia*, Annulment decision of 16 May 1986, (1986) 25 ILM 1439; *Mine v. Guinea*, Partial Annulment decision of 22 December 1989, (1990) 5 ICSID Rev-FILJ.95; for the discussion of the cases see Ch.III, *supra*, notes 149- 187 and accompanying texts.

<sup>76</sup> See Ch.VI, *supra*, 6.1.2.

<sup>77</sup> For an interesting example of the effects of the extra-legal considerations on the decisions of arbitral tribunals established following a bilateral treaty see Keisselbach, W., *Problems of German-American Claims Commission*, Translated by E.Zeydel, Washington D.C.: Carnegie Endowment for International Peace, Division of International Law 1930, 9-10.

<sup>78</sup> See Ch.III, *supra*, 3.4.2.

<sup>79</sup> See Ch.IV, *supra*, notes 23-7 and accompanying texts.

regime point to the influence of extra-legal interstate considerations on the regime of such arbitrations.<sup>80</sup>

From the above, it may be concluded that, in principle, the procedural and substantive determinations and the outcome of any kind of arbitration is heavily influenced by the overall interests of its designers. From this premise, a number of remarks can be made.

First, it is largely according to the above understanding that the appropriateness of a particular procedure for a particular kind of state contracts disputes can be measured. Accordingly, it may be concluded that, in principle, considerations relevant to the sovereignty of the state party are more likely to be taken into account in arbitrations rooted in an interstate agreement rather than a national law or a third legal order. Second, the understanding and recognition of the particular interest-orientation of a dispute settlement method would set aside the illusion of its universal neutrality and pave the way for the necessary procedural adjustments when dealing with a particular category of disputes. Furthermore, in light of the understanding of the above considerations, it will be possible for the arbitrators themselves to make, wherever possible, the necessary adjustments in a given case as required by various interests of the parties.<sup>81</sup>

Another important observation is related to the question of arbitration as an authoritative decision-making process. It would appear that the case-by-case basis of the solutions presented by state contract awards and the influence of extra-legal factors thereon render their value as precedent or their 'law-making' potential highly questionable.<sup>82</sup> There are other features of arbitration of state contracts which undermine the persuasive value of arbitral awards. Confidentiality, as an attractive

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<sup>80</sup> See Ch.VI, *supra*, 6.1.3.

<sup>81</sup> On the way individual can overcome their bias, Schachter maintains: "But even though human beings may not entirely escape their bias, it does not follow that the choice to be made is logically a subjective matter, as if it were a question of taste. The point is that a judgment among competing principles by an independent jurist can be made and justified on grounds that are valid for the relevant community of states, rather than on grounds held by the individual alone..." Schachter, *The Invisible College of International Lawyers*, 72 *Nw.U.L.R.* 217, 220, 221 (1977).

<sup>82</sup> Some commentators have suggested that arbitration can play a role in further development of the law of state contracts. See Paasivirta, *supra*, note 68 at 322-3.

feature of arbitration, imposes an obligation on arbitral tribunals not to publish their awards unless parties release them from this obligation.<sup>83</sup> Even when the awards are made public they are often published only in part; and if published in full, they rarely contain the arguments of the parties as they were presented. On this point Professor Lalive remarks:

“Reading what a number of papers have to say about some arbitration cases I happen to know, I was struck, once again, by the considerable difficulty there is, not only of correctly summing up a complex case in a few lines, but also of properly understanding an award when the only information available is... the text of the award itself!

With respect to the interesting discussion on publication of awards, I should like to add one, perhaps marginal comment: even when an award is published or is available, it remains very difficult in most cases to assess or understand it when you do not happen to know exactly what the position and arguments of the parties have been.”<sup>84</sup>

Since, state parties did not elect to participate in arbitral proceedings resulting in many of the awards cited and relied upon as authority, they do not contain the full arguments of the state parties. Therefore, such awards are not based on a balanced analysis of the opposing arguments on different legal and factual aspects of the disputes. This point is well illustrated in the awards relating to Libyan nationalisations.<sup>85</sup> As Fatouros rightly observes “[S]uch one-sided proceedings are hardly likely to lead to full investigation of the issues, however sensitive to the problem the arbitrator may be.”<sup>86</sup> He further considers the likely result of an arbitrator trying to take into account the possible legal arguments of a non-participating party and concludes that such an arbitrator would run “the risk of being accused of overstepping the bounds of (nominally) adversary proceedings.”<sup>87</sup>

The fact that, on certain issues of international law, awards of arbitral tribunals are

<sup>83</sup>See for example rule 9 of “Guidelines for International Arbitrators” prepared by International Bar Association, 1986, reproduced in (1987) ILM, 583. On the discussion of the origin and scope of the duty of confidence in arbitration see *Eso Australia Resources et al. v. The Minister for Energy et al.*, High Court of Australia, March 1944 and April 1995; Also *Hassneh Insce v. Mew* [1993] L.L.R. 243.

<sup>84</sup>Lalive, P., Arbitration with foreign States or state-controlled entities: some practical questions. In *Contemporary problems in international arbitration*, Edited by J. Lew, London: Kluwer 1986, 289.

<sup>85</sup>*BP Exploration Company (Libya) Ltd. v. The Government of the Libyan Arab Republic*, 53 ILR 297; *Libyan American Oil Company (LIAMCO) v. the Government of the Libyan Arab Republic*, 62 ILR 140; *Texaco Overseas Petroleum Company and California Asiatic Oil Company v. The Libyan Arab Republic*, Awards of 27 November 1975 and 19 January 1977 (Merits), 53 ILR 389; Commentary see Greenwood, C., State contracts in international law: the Libyan Oil cases, (1982) 53 BYIL 27; Kourdis and V. Mehren, International arbitrations between states and foreign private parties: The Libyan nationalization cases, (1981) 75 AJIL 476.

<sup>86</sup>Fatouros, A., International law and internationalised contract, *supra*, note 14 at 139-140.

<sup>87</sup>*Ibid.*

case-specific may be considered as the admission by such tribunals of their lack of ability to develop rules of international law on issues upon which the international community is divided.<sup>88</sup> Bearing in mind the consensual nature of international law and its close relationship to international relations, the further development of the rule of international law, in the relevant areas, will be more appropriately achieved within an international legislative framework.

Toope argues, arbitral awards' lack of persuasive value should not be "troubling" as arbitration is seen "primarily as a means to resolve specific disputes."<sup>89</sup> He notes that:

The process of arbitration is, as Fuller reminds us, a means of social ordering, but the impact of particular awards has typically been case specific. That distinction explains why court judgments are almost always public documents and arbitral awards are very often confidential. Of course, the content of a confidential award is immaterial at a systemic level, for it can have little impact. But even if an arbitral award from a mixed tribunal is made public, it should not be seen to play the same role as a court judgment. Whether or not the substantive content is contingent or idiosyncratic, therefore, should not be of great concern to those outside the scope of the particular arbitration.<sup>90</sup>

He further argues that contribution of mixed arbitrations (arbitrations between states and private parties) to the international rule of law should be judged on the basis of the working of the process rather than its outcome:

The simple fact that a state and a foreign private party are willing to structure their disputes in a reasoned manner and to settle them through an appeal to the rational decision of a third party, rather than resorting to mere fiat, enhances the rule of law.<sup>91</sup>

This further highlights the importance of a secondary role for arbitration of state contracts which is providing a framework for conciliation as well as third party adjudication.

The above account of arbitration of state contracts also makes it possible to speculate as to the future developments of the law relating to state contracts as well as the

<sup>88</sup> Resort by arbitral tribunals to equity and equitable considerations in such cases has been common. In this sense, it may be said that the arbitral tribunal creates new law for the parties. Lauterpacht, E., *Aspects of the Administration of International Justice*, Cambridge: Grotius publication 1991, 120. A question may arise as to the legal basis of the arbitrator's power to decide on the basis of equity. According international law, resort to equity by the international judge or arbitrator should be based either on the relevant authorisation granted by customary international law or a treaty, or by the parties' request to decide *ex aequo et bono*. *Ibid.* at 119. In a national law context, resort to equity by the arbitrator is only possible when is permitted by law or by the parties within the limits prescribed by law. Redfern and Hunter, *Law and Practice of International Commercial Arbitration*, 2nd edition, London: Sweet and Maxwell 1991, 35-38.

<sup>89</sup> Toope, *supra*, note 71 at 396.

<sup>90</sup> *Ibid.*

<sup>91</sup> *Ibid.* at 398-9.

prospect for resort to arbitration in this area.

Party autonomy subject to the mandatory laws of the state will continue to prevail in which case many aspects of state contracts will continue to be regulated by the law of the host state. In the absence of a choice of law clause by the parties, the applicable law will be determined as that of the state. Therefore, the changing demands of public interest in relation to a state contract may be fulfilled through state's unilateral intervention with contract regime. However this exercise of sovereign discretions by the state will be possible within the limits and subject to the requirements of international law, in particular the payment of compensation when it amounts to a taking. The question of the standard of protection of foreign investment and the measure of compensation will remain the main area of controversy.

The lack of precedential value of awards of state contracts arbitrations, somewhat rules out the role of arbitration as an authoritative decision-maker in respect of investment agreements in general and the standard of compensation for nationalisation in particular. In the light of its relationship to the fundamental philosophical differences between various interests groups among the members of the international community, the further development of the law on the question of standard of compensation will ideally be pursued through resort to collective bargaining within a multilateral treaty-making framework. In the short term however, given the strong desire shared by many developing states for attracting foreign investment and the insistence of capital exporting countries on the conclusion of BITs, such states will increasingly conclude bilateral investment treaties which provide for, among other things, arbitration and the standard of compensation for expropriation of foreign investment. Furthermore, arbitral tribunals faced with the question of determination of standard of compensation will continue to decide on a case by case basis.

In relation to state contracts disputes settlement, absent a proper supranational machinery, for the reason of protection of collective interest of the nation concerned, such disputes should ideally be settled in the courts of the state party subject to its laws. Therefore, state parties will continue to argue in favour of their national courts as the most appropriate forum for the adjudication of disputes arising from investment

agreements. Arbitration will be insisted upon by the private parties as one of the essential clauses of such agreements. Resort to arbitration therefore will in most cases rest on the stronger bargaining position of the private party. On the related question of what kind of arbitration will best meet the demands of host states with regard to both procedure and substance, it is clear that treaty-based arbitrations will, in principle, rank higher than international commercial arbitration.

In the context of treaty-based arbitrations, a distinction should be made, however between, on the one hand, those arbitrations which are established according to bilateral or multilateral treaties which have been designed to specifically deal with future investment disputes and arbitrations which are agreed upon after the dispute has arisen. In principle, arbitrations belonging to the first category are more likely to remain within the bounds of legal determination of the disputes, in that, the outcome of the process will be less affected by the extra-legal considerations including interstate political considerations. Furthermore, within this category, it may be argued that, in many cases, multilateral treaties such as ICSID may offer a regime more attuned to the requirements of the state party to the investment disputes than that of bilateral investment treaties. Multilateral treaties are the outcome of collective bargaining process between capital-importing and capital exporting countries, in which the former may have had a stronger voice in expressing their position. The regime and the outcome of arbitrations provided by treaties after the dispute has arisen may to a varying degree be affected by the overall interstate considerations.

In the context of national laws, as compared to transnational arbitration, arbitrations following a more traditional view on questions of arbitrability, procedural control and the determination of the applicable law are more likely to be preferred by the state parties as they are relatively more amenable to the public interest requirements of interested states. In the light of the lack of compatibility of transnational arbitration with both procedural and substantive needs of the sovereign party, there will be only a limited scope for this kind of arbitration as an appropriate method of state contracts dispute settlement.

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