UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

STATE CONTRACTS

UNCTAD Series
on issues in international investment agreements

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NOTE

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IIA ISSUES PAPER SERIES

The main purpose of the UNCTAD Series on issues in international investment agreements – and other relevant instruments – is to address concepts and issues relevant to international investment agreements and to present them in a manner that is easily accessible to end-users. The series covers the following topics:

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PREFACE

The secretariat of the United Nations Conference on Trade and Development (UNCTAD) is implementing a work programme on international investment agreements. It seeks to help developing countries to participate as effectively as possible in international investment rule-making at the bilateral, regional, plurilateral and multilateral levels. The programme embraces policy research and development, including the preparation of a Series of issues papers; human resources capacity-building and institution-building, including national seminars, regional symposia, and training courses; and support to intergovernmental consensus-building, as well as dialogues between negotiators and groups of civil society.

This paper is part of this Series. It is addressed to Government officials, corporate executives, representatives of non-governmental organizations, officials of international agencies and researchers. The Series seeks to provide balanced analyses of issues that may arise in discussions about international investment agreements. Each study may be read by itself, independently of the others. Since, however, the issues treated closely interact with one another, the studies pay particular attention to such interactions.

The Series is produced by a team led by Karl P. Sauvant and James Zhan. The principal officer responsible for its production is Anna Joubin-Bret who oversees the development of the papers at various stages. The members of the team include Federico Ortino, Sergey Ripinski and Jörg Weber. The Series' principal advisors are Peter Muchlinski and Patrick Robinson.

The present paper is based on a manuscript prepared by M. Sornarajah with inputs from Peter Muchlinski. The final version reflects comments received from Oscar Garibaldi, Joachim Karl, Christoph Schreuer and Thomas Wälde.

Carlos Fortin

Geneva, November 2004 Officer-in-Charge of UNCTAD

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UNCTAD has carried out a number of activities related to the work programme in cooperation with other intergovernmental organizations, including the Agence pour la Francophonie, Banco Centroamericano de Integración Económica, CARICOM Secretariat, German Foundation for Development, Inter-Arab Investment Guarantee Corporation, Inter-American Development Bank (BTD/INTAL), League of Arab States, Organization of American States, Secretaria de Integración Económica Centroamericana and the Secretaria General de la Comunidad Andina. UNCTAD has also cooperated with non-governmental organizations, including the Centre for Research on Multinational Corporations, the Consumer Unity and Trust Society (India), the Dutch Foundation for Research on Multinationals (SOMO) (the Netherlands), the Economic Research Forum (Egypt), the European Roundtable of Industrialists, the Friedrich Ebert Foundation (Germany), the German Foundation for International Development, the International Confederation of Free Trade Unions, the Labour Resource and Research Institute (LaRRI) (Namibia), Oxfam, the Third World Network and World Wildlife Fund International. Since 2002, a part of the work programme has been carried out jointly with the World Trade Organization (WTO).

Funds for the work programme have so far been received from Australia, Brazil, Canada, France, Japan, the Netherlands, Norway, Sweden, Switzerland, the United Kingdom and the European Commission. Argentina, Botswana, China, Colombia, Costa Rica, Croatia, Cuba, Czech Republic, Djibouti, Egypt, Gabon, Germany, Guatemala, India, Indonesia, Jamaica, Malaysia, Mauritania, Mexico, Morocco, Namibia, Pakistan, Peru, Qatar, Singapore, South Africa, Sri Lanka, Thailand, Trinidad and Tobago, Tunisia, Venezuela and Yemen have also contributed to the work programme by hosting regional symposia, national seminars or training events.

In pursuing this programme of work, UNCTAD has also closely collaborated with a number of international, regional and national organizations, particularly with the Centro de Estudios Interdisciplinarios de Derecho Industrial y Económico (the Universidad de Buenos Aires), the Indian Institute of Foreign Trade, the Legon Centre of Accra (Ghana), ProInversión (Peru), Pontificia Universidad Católica del Perú, the National University of Singapore, Senghor University (Egypt), the University of Dar Es Salaam (Tanzania), the University de Los Andes (Colombia), the University of Campinas (Brazil), the University of Lima (Peru), the Universidad del Pacífico (Peru), the University of Pretoria (South Africa), the University of Tunis (Tunisia), the University of Yaoundé (Cameroon), the Shanghai WTO Affairs Consultation Center (China) and the University of the West Indies (Jamaica and Trinidad and Tobago). All of these contributions are gratefully acknowledged.

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EXECUTIVE SUMMARY

One common mode of entry for foreign direct investment is through the making of a foreign investment contract with the State. State contracts have played a major role in the foreign direct investment process, especially in developing countries that are dependent upon the exploitation of natural resources for their economic welfare. Often, operation in a sector, such as petroleum, is open only to a State entity or through the making of a contract with the relevant State entity.

The issue of State contracts, as it relates to international investment agreements, concerns a number of specific matters. First, the extension of investment agreements' protection to State contracts depends on the scope of the definition of investment, the exclusion of certain State contracts from their coverage and in how far dispute settlement provisions of the agreements apply to State contracts. Arbitral tribunals have interpreted so-called umbrella clauses differently so that their protective effect cannot be fully assessed yet. Second, the preservation of host country discretion in the negotiation, conclusion and regulation of State contracts can be based on inscribing the basic principle of good faith and periodic review into an international investment agreement. Third, the duties towards private investor parties to State contracts compensate for the more favourable position of the State by allowing for clauses on stabilization, choice of law, arbitration and the breach of contract on the part of the host country government. Fourth, the development of substantive regimes of State contracts in international investment agreements is related to the commitment on the side of the government.

The conclusion identifies three policy options. First, countries that want to maintain complete freedom of action in relation to State contracts and avoid as far as possible international investment protection standards can exclude State contracts from international investment agreements. This option might signal caution to foreign investors, in cases when the host country's legal system does not fully protect investors' rights. Second, countries wishing to extend protection to foreign investment, but maintain regulatory discretion, can opt for a limited protection of State contracts under international investment agreements by means of positive and negative lists, restrictions on the definition of contractual breaches and dispute settlement clauses, the exclusion of certain protection standards and an umbrella clause, as well as the inclusion of public policy exceptions. Third, full protection for investors into State contracts under international investment treaties can be achieved through unlimited definition of investment, unconditional dispute settlement, an umbrella clause and stabilization commitments.

INTRODUCTION

A "State contract" can be defined as a contract made between the State, or an entity of the State, which, for present purposes, may be defined as any organization created by statute within a State that is given control over an economic activity, and a foreign national or a legal person of foreign nationality. State contracts can cover a wide range of issues, including loan agreements, purchase contracts for supplies or services, contracts of employment, or large infrastructure projects, such as the construction of highways, ports or dams. One of the commonest forms of State contracts is the natural resource exploitation contract, sometimes referred to as a "concession agreement", though this is not a strict term of art (Brownlie, 2003, p. 522). Such agreements feature prominently in the natural resource sectors of developing countries. Historically, these sectors have provided the most important source of income for the domestic economy and have often been State controlled, so that foreign entrants into the sector had to make contracts with the State entity in control[1].

A common mode of entry for foreign investors, especially into developing countries, is through the making of a foreign investment contract with the State or a State entity. This is often the case in sectors in which the State entity functions as a statutory monopoly under local laws. As a result, State contracts assume a special importance in the making of foreign direct investment (FDI) in developing countries. It is against this background that the issue of how international investment agreements (IIAs) treat State contracts needs to be considered. In particular, the extent to which IIA provisions can regulate the behaviour of countries, in their use and operation of State contracts, is a major concern.

This becomes all the more important when it is borne in mind that State contracts are generally viewed as being different from ordinary commercial contracts. Given the strong public policy considerations that may underlie governmental contracting, whether in relation to FDI projects or other State sponsored economic functions, an element of public law regulation and governmental discretion is often asserted in relation to the negotiation, conclusion, operation and termination of such contracts. The distinction between ordinary commercial contracts between private parties and a State contract made between a private party and a State or its entity is universally recognized in several domestic legal systems (especially in the French *"contrat administratif"* concept), although the precise approach varies from system to system (Turpin, 1972; Langrod, 1955). Generally, domestic legal systems treat contracts made with the State or State entities as a special category of contract subject to specialized regulatory rules.[2] For example, the rules of capacity of a State entity to make contracts will be stated in the legislation creating it, which may also identify the types of areas in which the State entity has the capacity to conclude contracts. Equally, the source of the law applicable to the contract is usually to be found in statutes and regulations on the subject matter of the contract as well as on the State entity concluding the contract.[3] Often, operation in sectors, such as the petroleum sector, is open only to a State entity or in association with a State entity. Thus, entry into such a sector by other investors is possible only through the making of a contract with the relevant State entity.

In addition, domestic legal systems normally have restraints on the manner in which public funds are spent and received, and subject such matters to careful scrutiny through regulatory laws.[4] Ministerial signature of a contract may be a requirement, and there may be other specific procedures for review and scrutiny of the contract. The requirement for such care in controlling capacity and procedure itself indicates that State contracts are quite different from ordinary commercial contracts as they implicate State interests and may involve large parts of a State's financial and other resources.

Finally, the termination of a State contract may depend on conceptions of public need. This may attract rules for determining damages that are not entirely based on the commercial considerations that may apply to ordinary contracts. The means of termination may also differ between ordinary commercial contracts and State contracts. While both may be terminated by breaches, State contracts are often terminated, or their performance made wholly or partially impossible, by State action. Under several theories of domestic law, the power of the legislature may not be restricted by the existence of contractual commitments, although as a rule compensation may be owed under constitutional protections.[5]

As a result of such public policy-based control and discretion, the balance of rights and obligations under State contracts may favour the governmental party, for policy reasons that the governmental parties consider entirely legitimate. At the same time that balance can expose the private contracting party to the risk of interference with the commercial expectations that have induced the latter into the contract. It is this commercial risk that has motivated the development of rules of customary international law on State responsibility for breaches of State contracts. The main reason for the "internationalization" of States contracts is the concern over the impartiality of domestic courts and the objective to neutralize the in-built superiority of host country institutions, because of their sovereign powers of legislation abrogating or interfering with contracts. If such concerns would not exist, the need of the separate category of State contracts and their international protection by treaties and arbitration clauses disappears. Many of the most significant early foreign investment disputes concerned the operation and termination of such contracts, in particular, through renegotiation, expropriation or nationalization (Muchlinski, 1999, ch.14). These disputes resulted in international arbitral awards that considered and developed the relevance of State contracts and of the doctrines associated with such contracts to the international law on foreign investment.[6]

State contracts were regarded to be subject, in principle, to the domestic laws of the host country but at least in the case of petroleum contracts, a tendency developed in the 1950s to regard these contracts as subject to a process of "internationalization". Such contracts came to be regarded as "economic development agreements", which should be subjected to international legal norms. Under the traditional view, the conditions for the validity of a State contract, including such matters as the capacity of the parties and the process of formation of a contract, are governed by the domestic law of each host country. It is recognized that, even in regimes subject to IIAs, if the contract in pursuance of which a foreign investment is made is illegal and void in terms of the domestic law, there is no scope for the invocation of a treaty to protect the investment.[7] The theory of internationalization of contracts suggests, however, that the obligations arising from a contract may reside in an external system.[8] This external system is variously described as transnational law of business, general principles of law, *lex mercatoria* and even as international law. This theory states that the use of certain clauses may have the effect of internationalizing the contract for certain purposes, at least those connected with termination and dispute resolution.[9]

One purpose of IIAs has been to bring about settled norms as between the parties to deal with a conflict. State contracts and the conflict of doctrines associated with them may be seen as a core purpose of making investment treaties. In this respect, IIAs are not normally designed to protect an individual contract, which is left for the parties to negotiate, but to ensure the stability of the operating structure of the investment within the host country (which may include investments covered by State contracts).

Accordingly, the aim of this paper is to consider more specific IIA provisions that act to affect the negotiation, conclusion and observance of State contracts by both the governmental and private parties. The substantive standards of treatment that governments may be expected to observe, in relation to foreign investors that are parties to State contracts, are covered by other papers in this Series.

Notes

[1] For a recent discussion of State contracts, see Leben, 2004.

[2] Some States have legislation governing such contracts. See, for example, the Government Contract Act in India and in Malaysia. That is not to say, however, that there is complete convergence between national laws on how this is to be done. For example, under French law a developed doctrine concerning administrative contracts (*contrat administratif*) has evolved, while in common law countries public law considerations have been introduced into general principles of the common law of contract to cover government contracts.

[3] Thus, in some States, a State entity cannot subject itself to arbitration abroad. There may also be restrictions as to choice of external legal systems. Such restrictions will not exist in the case of ordinary commercial parties.

[4] For practice in Australia, see Fitzgerald, 2002, pp. 37-52.

[5] See e.g. the decision by the United States Supreme Court in United States v. Winstar that upheld the validity of contracts against legislative abrogation (116 SCT 2432 (1996)).

[6] For the literature on state contracts in international investment law, see Fatouros, 1962, 1969; Amerasinghe, 1967, pp. 66-119; Paasirvirta, 1990; Nassar, 1995, pp.133-135; Sornarajah, 2000, pp. 85-112; Bowett, 1988, pp. 49-74; Maniruzzaman, 2001.

[7] See *Azinian v. Mexico,* Award of the Tribunal, para. 100.

[8] This is a contested theory. Its proponents argue that the use of certain phrases (such as choice of law clauses) indicating transnational law, stabilization clauses that freeze the host country law at the time of entry and arbitration clauses which indicate arbitration outside the State have the effect of internationalizing the contract. See Schwebel (1987) on whether the breach by a State of a contract with an alien is a breach of international law. For a critical view, see Sornarajah, 2004.

[9] See especially Texaco/Calasiatic v. Libya, 53 ILR (1979), pp. 389. Critical: see Sornarajah, 2000, pp.223-278. For a similar conflict of norms, see the development and relevance of the Calvo doctrine in international investment law: Shea, 1955; Fatouros, 1962, 1969; Schrijver, 1997.

Over the past ten and in particular five years, an extensive arbitral jurisprudence has developed based on IIAs. This jurisprudence may gradually be developing an international law of State contracts in applying the usually very open-ended provisions of investment treaties to specific situations. For a recent study of the contribution of recent investment arbitration, see Benhamida, forthcoming. For an up to date discussion on the contribution by recent NAFTA Chapter XI arbitrations, see Weiler 2004. For a review of investment disputes arising from BITs and NAFTA, see UNCTAD forthcoming.

SECTION I
EXPLANATION OF THE ISSUE

As noted in the Introduction, the process of negotiation, conclusion, operation or termination of a State contract is of relevance to IIAs as it often forms the legal basis of the investment relationship between a foreign investor and a host country. Indeed, State contracts can be seen as part of a multiplicity of legal norms that affect the conduct of a host country's FDI policy and, by extension, its relations with particular investors. Apart from the State contract itself, the investment relationship is governed by applicable rules of national law and policy, any bilateral investment agreements (BITs) concluded between the host and home country of the investor, any applicable regional or multilateral regimes and customary international law.

The issue of State contracts, as it relates to IIAs, concerns a number of specific matters:

- *The extension of IIA protection to State contracts.* At the outset it should be made clear that, in the absence of specific provisions of the type discussed below, an IIA, whether bilateral, regional or multilateral, does not automatically cover matters relating to State contracts. This is so even if an IIA incorporates by reference the standards of customary international law, because it is generally accepted that not every breach of State contract on the part of a State automatically entails a violation of international law, or a breach of an applicable IIA. It is generally accepted that, for such an effect to ensue from a governmental breach, this action must amount to a breach of international law, as where the breach amounts to a denial of justice or expropriation without adequate compensation, or a breach of an international agreement by which the host has accepted international responsibility for breaches of contractual obligations owed to nationals of other contracting States (Schreuer, 2004, pp. 249-250) or a breach caused by an act taken in a government capacity, as distinguished from a mere commercial act.[1] Such a jurisdiction must be included in the agreement, especially given the public policy sensitivity surrounding the process of governmental contracting with private parties. This may be accomplished through the definition of investment used in the agreement, and through any dispute settlement provisions that delimit the types of investment dispute that can be placed before the investor-State dispute settlement system offered under the terms of the agreement.

Also, numerous IIAs contain provisions granting protection for obligations assumed by a host country towards foreign investors, thereby bringing such obligations within the protection of the IIA. Such clauses are termed “umbrella clauses”. They add compliance with investment contracts, or other undertakings of the host country, to the substantive standards of the IIA. A violation of the investment contract becomes thereby a violation of the applicable IIA (Schreuer, 2004, p. 250).

- *The preservation of host country discretion in the negotiation, conclusion and operation of State contracts.* As noted in the Introduction, State contracts are often used in politically sensitive investment areas. Thus, they are usually subject to a special legal regime that gives considerable discretion to the government in the contractual process. This regime is an expression of a government’s right to regulate an investment in accordance with its national policy priorities. In effect, the national legal regime aims to preserve national policy space (UNCTAD, 2003a, chapter V). Given the protection offered to investors under the legal regime of IIAs, the exercise of certain discretionary powers by a host country under the applicable national legal order pertaining to State contracts may entail interference with an investor's protection rights established in the IIA. In order to avoid such an eventuality, and as a means of preserving the host country’s legitimate rights to regulate in the national policy interest, IIA provisions can be drawn up to recognize the need for such policy space on the part of the host country. In the first place, the definition and scope provisions of an IIA can be drafted so as to preserve national discretion in the regulation of investments made through a State contract. In addition, provisions can require the negotiation and implementation of State contracts in good faith on the part of the investor and the State; allow for periodic review; reaffirm national sovereignty over certain types of economic activity (see e.g. the Energy Charter Treaty, Art. 18); recognize the legitimacy of certain kinds of regulatory action in relation to investors, such as, for example, controls over illicit payments and the extension of competition laws to their activities; and preserve discretion to take measures for national security or other vital public policy reasons. In seeking to include such measures in IIAs, governments need however to consider the kind of signal they may be sending to potential investors.

- *Duties of the State towards private investor parties to State contracts.* In addition to the preservation of national policy space, IIAs can also introduce certain provisions that seek to establish certain duties of the State towards private foreign investors who enter into State contracts. This may reflect the concern that such parties can be adversely affected by the tendency of national State contract regimes to favour the State party. Such provisions can cover a range of possible questions, including, for example, the preservation of confidentiality of commercially sensitive information obtained by the State contracting party in the course of the conclusion of the State contract; a duty on the part of the host country government to negotiate in good faith; a commitment to accept responsibility for breaches of the State contract going beyond the express terms of an umbrella clause which requires mere observance of obligations; and the acceptance of an obligation to stabilize the national legal regime applicable to the State contract by undertaking not to make subsequent legal changes that affect the regulatory regime to which the contract is subject.

- *Development of substantive regimes of State contracts in IIAs.* It is rare to find IIA provisions that seek to affect the substantive detail of State contracts[2]. However, the content of such national laws and policies may lead to the application of provisions that are incompatible with the broad terms and objectives of international investment regimes as expressed in IIAs or in wider ranging free trade agreements that contain an investment element. For example, a State contract could contain a preferential treatment provision that ensures the government will privilege the private investor party to the agreement over other foreign investors, contrary to the most-favoured-nation (MFN) principle. This has been a particular concern in the area of government procurement contracts. Such contracts can be seen as investment contracts where they involve the commercial presence of the private foreign party, as in the case of a long-term construction project, or a long-term services supply agreement. It is now the case that certain more recent free trade agreements are beginning to include some detailed provisions on the conduct of government procurement contracts. While it is hard to say that a trend is emerging towards the inclusion of detailed provisions on the substantive content of State contracts as such, this development is at least worthy of note, as a departure into the development of substantive international treaty obligations that may affect the operation and content of national contracting policies.

Notes

[1] There are several recent arbitral awards (on jurisdiction) that deal with the relationship between treaty arbitration on the one hand, and (concession) contracts under domestic law and with domestic jurisdiction clauses, on the other. Notably, CMS vs. Argentina, Azurix vs. Argentina, Siemens vs. Argentina, and most authoritatively, the decision of the ICSID annulment committee in the Vivendi-Argentina case (see. www.worldbank.org/ ICSID).

[2] Except in intergovernmental agreements signed in the past by socialist countries, or in project-specific intergovernmental agreements (e.g. for the Channel tunnel).

SECTION II
STOCKTAKING AND ANALYSIS

There are not many instances of direct reference to State contracts in IIAs. A contract is primarily a matter for the parties involved. States normally provide the operating conditions for contracts not only for purely domestic but also for State contracts. For this reason, it is not common for an IIA to make direct reference to State contracts as such, despite the obvious importance of State contracts for FDI. Nonetheless, the issues identified in the previous section do appear in the provisions of IIAs, and each will be examined in turn.

A. The extension of IIA protection to State contracts

1. Definition of State contracts in IIAs

The extent to which IIAs cover State contracts depends first of all on the scope of the definition of investment provided for in an agreement. The concept of "investment" is not static, but can evolve to meet new expectations. The extension of IIA coverage to State contracts is therefore possible, given the use of an appropriate definition.

This is dependent on the application of a wide asset-based approach that includes "every kind of asset" and which elaborates on this general phrase with an express reference to breach of contractual obligations, owed by the host country to an investor of another contracting country, as a type of protected asset. This category can include rights such as those created by concession agreements conferring on an investor the right, for example, to search for, extract or exploit natural resources (UNCTAD, 1998, p. 35). Examples of such provisions may be found in the 1994 BIT between Ecuador and the United Kingdom[1] which extends to "business concessions conferred by law or under contract, including concessions to search for, cultivate, extract or exploit natural resources" (Article 1(a)(v)) and in the 1995 BIT between Canada and the Philippines which covers “rights, conferred by law or under contract, to undertake any economic and commercial activity, including any rights to search for, cultivate, extract or exploit natural resources” (Article 1(f)(vi)).[2]

The concession agreements that are usually referred to in these provisions are a variety of State contract. The purpose of their inclusion is usually to ensure that agreements in natural resources industries come within the definition of investments. Petroleum and natural resources contracts played a dominant role in the development of this area of the law and continue to receive attention because of the amount of investment that takes place in the sector. The term "business concessions" used in the treaties may be regarded as wide enough to capture terms in foreign investment contracts that confer special privileges upon an individual foreign investor.[3] What is contemplated are privileges that lie within the sole prerogative of the State. Some treaties specifically refer to “business concessions under public law”.[4] Rights over natural resources lie within such public law powers.

There are also a few treaties that define foreign investment as including the whole range of contractual rights. Such treaties may have the effect of extending the scope of the treaty's investment disciplines to include contract-based rights.[5] An example is the following formulation:

> “contractual rights, such as under turnkey, construction or management contracts, production or revenue-sharing contracts, concessions, or other similar contracts”.[6]

Such a formulation is broad enough to capture a large number of contractual rights, even those that do not fall within the realm of public law. The inclusion of such a provision may elevate the whole contract into the realm of treaty protection.

Apart from long-term contractual rights, such as licensing, management, franchise or turnkey contracts, protected contract rights may also include certain short-term rights such as claims to money and performance. However, contracts requiring immediate payment are unlikely to be seen as “investment” (UNCTAD, 1998, p. 35).

In addition, the definitional provision may capture so-called “new property” such as administrative licenses and permits necessary to carry out the activity of the foreign investor in a host country. Screening laws require that a contract be submitted to, approved by and later be supervised as to its functioning by an administrative agency of the host country. This requires that, from the point of view of protection, the administrative licenses that are obtained by a foreign investor also be treated as property of the foreign investor and be protected. The 1994 Energy Charter Treaty, in Article 1(6)(f), defines investment to include “any right conferred by law or contract or by virtue of any licenses and permits granted pursuant to law to undertake any Economic Activity in the Energy Sector”. In such instances, the IIA objective to neutralize the public law element is visible in the fact that the withdrawal of such licenses (once granted) is subject to treaty provisions. The licenses themselves, though not forming a part of the contract, are granted on the basis of the contract that has been formed and could properly be taken to be part of such contract.

2. Exclusion of certain State contracts from IIA coverage

A few IIAs, especially those adopting a general broad definition of investment covered by an agreement, tend to exclude certain types of contracts from their scope. For example, Article 1139 (h) of NAFTA excludes government procurement contracts from the scope of the chapter on investment in the provision on definition of investment. It states that:

> "[…] investment does not mean claims to money that arise solely from (i) commercial contracts for the sale of goods or services by a national or enterprise in the territory of a Party to an enterprise in the territory of another Party".

This provision excludes private sales contracts, but it also seems to exclude sales contracts made with State enterprises.[7]

3. Dispute settlement provisions

As to the issue of dispute settlement, in order for an IIA dispute settlement clause to deal with disputes arising between a host country and a foreign investor under the State contract between them, it must be clear that this clause extends to breaches of obligations other than those found in the IIA itself. This is dependent on the wording that extends the jurisdiction of the dispute settlement body in question to any dispute "relating to investment" or "concerning the investment", thus making clear that not only breaches of the IIA but also breaches of other obligations owed to the foreign investor, such as those found in the State contract that forms the legal basis of the investment.[8]

It is arguable that, where the definition of "investment" is wide enough to cover State contract obligations it may be presumed that disputes arising out of a State contract are within the jurisdiction of the dispute settlement body, in the absence of any express exclusion of such obligations from the dispute settlement clause. This view is reinforced in the case of agreements that contain an "umbrella clause", as explained in the next section.

4. Umbrella clauses

There are general provisions in some IIAs that refer to the protection of obligations undertaken towards the nationals of other parties (box II.1). For example, Article 2(2) of the 1983 BIT between St. Lucia and the United Kingdom requires that:

> "each Contracting Party shall observe any obligations it may have entered into with regard to investments of nationals or companies of the other Contracting Party".

Such clauses have been referred to as "umbrella clauses".

There is some uncertainty as to the precise nature and effect of these clauses. On the one hand, it has been asserted that such provisions protect an investor's contractual rights against "any interference which might be caused by either a simple breach of contract or by administrative or legislative acts" (Dolzer and Stevens, 1995, p. 82). Such a provision is included in a BIT in order to avoid the uncertainty under general international law whether such breaches of contract constitute infringements of international law. However, it is unclear whether the obligation that is created vis-à-vis the two State parties to the contract can be enforced by the foreign investor itself.[9]

This issue has generated some recent case law. In particular, two recent arbitral decisions brought by the Swiss-based transnational corporation (TNC) Société Générale de Surveillance (SGS) against Pakistan and the Philippines have attempted, without much success, to clarify the extent to which an investor's claim against a host country government for breach of contract can be elevated to a claim under a BIT by relying on an umbrella clause in a BIT between the investor's home country and the host country. In each case, the central question was whether, through the umbrella

Box II.1. Umbrella clauses

From model BITs practice, at least two main approaches may be discerned with regard to the use of umbrella clauses. Most European model BITs, should they include such a clause, do so within the article on promotion and protection of investment. The clause usually reads as follows: "Each Contracting Party shall observe any obligation it may have entered into with regard to investments of nationals or companies of the other Contracting Party" (1991 United Kingdom model BIT, Article 2(2); see also 2000 Denmark model BIT, Article 2.3, and the 2002 Sweden model BIT, Article 2(4)). The Swedish model is notable for the fact that the umbrella clause is combined with the full protection and security standard.

A further approach is exemplified by Article 8(2) of the German model BIT, which includes a provision almost identical to the umbrella clauses found in the majority of European model BITs in a non-derogation article. Article 8 of the German model BIT reads as follows:

"1. If the legislation of either Contracting State or obligations under international law […] contain a regulation […] entitling investments by investors of the other Contracting State to a treatment more favourable than is provided for by this Treaty, such regulation shall to the extent that it is more favourable prevail over this Treaty.

2. Each Contracting State shall observe any other obligation it has assumed with regard to investments in its territory by investors of the other Contracting State."

Source: UNCTAD.

clause in the applicable BIT, the investor's contractual claims against the host country (for breaches of contracts entered into for the provision of pre-shipment customs inspection services) could be resolved under the arbitration provisions of the BIT, rather than under the dispute resolution provisions of the contract under dispute.

The arbitral tribunal in *SGS v. Pakistan*[10] had to interpret Article 11 of the 1995 BIT between Pakistan and Switzerland, which reads as follows:

> "Either Contracting Party shall constantly guarantee the observance of the commitments it has entered into with respect to the investments of the investors of the other Contracting Party."

The tribunal held that, unless expressly stated, an umbrella clause does not derogate from the widely accepted international law principle that a contract breach is not by itself a violation of international law, particularly if such contract had a valid forum selection clause. The tribunal added that the umbrella clause was not a "first order" standard obligation; rather, it provided a general pledge on the part of the host country to ensure the effectiveness of State contracts. A different interpretation would make many of the articles in the treaty "substantially superfluous".[11] The Tribunal noted that:

> "There would be no real need to demonstrate a violation of those substantive treaty standards if a simple breach of contract, or of municipal statute or regulation, by itself, would suffice to constitute a treaty violation on the part of a Contracting Party and engage the international responsibility of the Party".[12]

Moreover, the structure of the treaty and the place in which the umbrella provision appeared also led the tribunal to conclude that the provision did not elevate the contract into the protection regime of the treaty. The precise interpretation to be given to that provision, as well as the rationale of umbrella clause, was, however, left unclear. If the customary law principle that no international obligations arise from the mere breach of a foreign investment agreement were to be changed, one would assume that this would have been done through the precise use of language evidencing the intention of the parties.

The arbitral tribunal in *SGS v. the Philippines*[13] returned to the question of the effect of an umbrella clause. While the contract between SGS and the Philippines provided that the courts of the Philippines would have exclusive jurisdiction over disputes under the contract, SGS commenced ICSID arbitration proceedings on the ground that its contract claim could be elevated to a treaty claim under the umbrella clause of the BIT between the Philippines and Switzerland. In this case, the tribunal (not being bound by a strict doctrine of precedent) interpreted the umbrella clause in a way diametrically opposed to the interpretation adopted by the previous tribunal. It held that the umbrella clause did, in principle, have the effect of conferring jurisdiction on an arbitration tribunal constituted under the BIT to determine purely contractual claims between an investor and the host State. The tribunal disagreed that the umbrella clause was merely a "second order" protection, instead preferring the view that the clause "means what it says". However, the tribunal held that even though it had jurisdiction under the BIT to arbitrate purely contractual claims, it would not exercise such jurisdiction in the case at hand since the parties had agreed to submit their contractual disputes to the exclusive jurisdiction of the Philippines courts. The investor should not commence arbitration based on the host country's breach of contract if arbitrating the dispute would not be in compliance with the dispute resolution provision of the same agreement. Consequently, the tribunal stayed its own proceedings in favour of the Philippines courts.[14]

The above cases do not offer a uniform or clear approach to the umbrella clause. From the perspective of an investor, the approach taken by the *Philippines* tribunal would offer greater protection, as it would make clear that a breach of a State contract amounts to a breach of a primary obligation in the BIT, placed upon the host country by the umbrella clause, to observe contractual commitments (Schreuer, 2004, p. 255). On the other hand, the interpretation taken in the *Pakistan* case gives greater discretion to the host country to interfere with the contractual relationship with the investor and to have that action judged, not by reference to the mere fact of a breach of the underlying investment contract (which may well be entirely lawful under the national laws and policies of the host country), but by reference to other substantive treatment standards in the BIT. These require a more difficult standard of proof and, as a result, the protection offered by the BIT applies only where an investor meets that standard. It will not be met by reference to the breach of the State contract alone. Arguably, this approach could be seen as depriving the umbrella clause of any independent meaning, in that it would annul any possibility of viewing a breach of an obligation entered into by the host country under a State contract as amounting to a breach of the BIT by reason of an infringement of the umbrella clause.[15]

B. Preservation of host country discretion and the creation of investor duties in the negotiation, conclusion and operation of State contracts

A significant issue that IIAs deal with in relation to State contracts concerns the preservation of host country discretion over this process and the creation of certain duties for the private party.

In particular, IIA provisions may contain requirements on the part of an investor and a government to negotiate in good faith and for periodic review of the State contract. These objectives were introduced into the 1983 Draft United Nations Code of Conduct on Transnational Corporations, in its provisions concerning review and renegotiation of contracts (paragraph 11).[16] By this provision:

> "Contracts between Governments and transnational corporations should be negotiated and implemented in good faith. In such contracts, especially long-term ones, review or renegotiation clauses should normally be included.
>
> In the absence of such clauses and where there has been a fundamental change of the circumstances on which the contract or agreement was based, transnational corporations, acting in good faith, shall/should co-operate with Governments for the review or renegotiation of such contract or agreement.
>
> Review or renegotiation of such contracts or agreements shall/should be subject to [the laws of the host country] [relevant national laws and international legal principles]."

This formulation, including the alternative negotiating drafts, expresses exactly the essence of the conflict of norms concerning the operation of State contracts, described in the Introduction. In particular, while there was agreement on the issue of negotiation in good faith (an obligation that applied not only to a TNC but also to the host country government) and on the value of a renegotiation clause in such contracts, there was no agreement as to the legal force that this provision should have, nor upon the applicable laws. Developing countries would have favoured a binding provision in which national laws prevailed, while the major capital exporting countries would have preferred a non-binding provision and the application of national and international laws to the process. The disagreement over the status and effect of renegotiation clauses further reflected the uncertainty that existed at the time of the draft United Nations Code over whether changed circumstances could require a renegotiation, or whether this would undermine the theory of internationalization of contracts, which is built on the notion of the sanctity and immutability of contracts.

Apart from the draft United Nations Code, no explicit references to renegotiation appear to exist in IIAs. However, the 1985 Draft United Nations Code on the Transfer of Technology contained some more detailed provisions on the conduct of negotiations leading towards a technology transfer agreement (see Chapter 5 "Responsibilities and Obligations of Parties"). Given that the draft Code on the Transfer of Technology contains a definition of "party" to a technology transfer agreement, which includes "States, Government agencies…. when they engage in an international transfer of technology transaction which is usually considered to be of a commercial nature…", it is clear that the provisions of Chapter 5 of the draft Code could apply to State contracts for the transfer of technology. The thrust of these provisions was to emphasise the need of the parties to be responsive to the economic and social development objectives of, in particular, the technology acquiring country and to observe fair and honest business practices, taking into account the state of development of the country concerned. Equally, requests for relevant information should be met and confidentiality protected.

In order to meet the issue of changed circumstances, a system of periodic review may be built into the terms of an IIA. One example comes from the 1999 Agreement between Azerbaijan, Georgia and Turkey Relating to the Baku-Tbilisi-Ceyhan Main Export Pipeline.[17] Article VI of this Agreement establishes an inter-governmental Implementation Commission. According to Article VI (2), its task is to provide a consultation forum for both the Governments parties to the Agreement and the project investors, in order to give prompt and effective assistance on the implementation of the pipeline project as well as to resolve, in good faith, any complications, issues, problems or disputes that may arise in connection with the Agreement, or to discuss any matter relating to the interpretation, application or enforcement of the Agreement. This provision is notable, as it appears wide enough to permit for the review, and possibly renegotiation, of certain terms of the Agreement, with the project investors.

C. Duties towards private investor parties in State contracts

As noted in the Introduction, the fact that a State or a State entity is one of the parties to a contract means that the State party is in a more favourable position, given that it has legislative and administrative power. The counterbalancing of this element of State power in a foreign investment contract is normally left in the hands of the foreign investor, as part of the negotiating process. This has resulted in the development and use of several types of contractual clauses that seek to protect the interests of foreign investors against arbitrary and unwarranted interference. These include *stabilization clauses,* which seek to preserve the law of the host country as it applies to the investment at the time the State contract is concluded, and which ensures that the future changes to the law of the host country are inapplicable to the foreign investment contract; *choice of law clauses,* may refer to a supranational system of law, such as transnational law, general principles of law or even international law, thereby putting the contract beyond the host country’s law; and *forum selection or arbitration clauses,* which have the effect of allowing an investor to submit disputes arising under the contract to an international tribunal usually constituted outside the territory of the host country. These clauses, either together or independently, can "internationalize" the transaction rather than subject it to the domestic law of the host country. The ability of such clauses, especially the stabilization clause, to fetter the legislative sovereignty of the host country is often doubted.[18] But arbitral awards have given effect to such clauses as indicating that they seek to achieve contractual stability at least for short periods (Tschanz, 1984). However, the question remains whether such clauses receive protection also from IIAs. On the whole, there is little practice in IIAs that bears expressly upon this problem. On the other hand, certain examples exist of provisions that seek to establish duties on the part of a host country in its dealings with investors under State contracts.

Turning, first, to stabilization clauses, no IIA contains such a clause as an international treaty obligation. However, the Italian model BIT states, in Article XII (3):

> "After the date when the investment has been made, any substantial modification in the legislation of the Contracting Party regulating directly or indirectly the investment shall not be applied retroactively and the investments made under this Agreement shall therefore be protected."

While not amounting to a full stabilization clause, in that it permits subsequent changes in the laws and regulations that apply to the investment, this provision makes clear that such changes cannot apply retroactively.

A possible way by which the stabilization of legal conditions can be introduced into an IIA is displayed by the 1999 Agreement between Azerbaijan, Georgia and Turkey Relating to the Baku-Tiblisi-Ceyhan Main Export Pipeline. By Article II thereof, the contracting States warrant to each other that they shall promptly ratify this Agreement in accordance with their respective domestic constitutional requirements, take all steps necessary to establish the legal regime applicable to the pipeline construction project (the MEP Project) that is the subject of the Agreement, and that there are no obligations, whether in domestic or international legal commitments, that may conflict with the terms of this Agreement. This warranty is further reinforced by the terms of Article II (7), which expressly relates the warranty to conformity of domestic and international legal commitments with the terms of the host country government agreement that each contracting State is to sign with the consortium of investors that are to undertake the project, that is the State contract used for this project. Article II (7) goes on to add to the warranty of conformity "any rights, privileges, exemptions, waivers, indemnifications or protections granted or arising under this Agreement or the other applicable Project Agreements". "Other Project Agreements" is defined as meaning "all written agreements and documented commitments, other than this Agreement and the Host Government Agreements, entered into by a State and/or any State Authority, on the one hand, and any Project Investor,[19] on the other hand, with respect to the MEP Project, as any or all of the foregoing agreements may be hereafter entered into, amended, modified or extended in accordance with their terms" (Article I). Therefore the warranty can cover all relevant agreements and commitments made to investors in relation to the MEP Project. It should be added that the host country government agreements contain a stabilization clause in Article 7(2)(xi), which defines a change in the law that must be rectified by the host country government as including inconsistent national or international obligations. Thus, to the extent that the intergovernmental agreement requires no inconsistency with the terms of the host country government agreement, this can be taken to include the need to ensure conformity with the stabilization clause contained in that agreement.

Other IIAs do not have such detailed provisions concerning the duties of government parties. However, certain provisions can be found that offer a degree of protection to the non-governmental party. For example, the United Nations draft Code of Conduct on TNCs placed the obligation to negotiate in good faith not only upon the TNC party but also on the host country government (paragraph 11). In addition, the United Nations draft Code required the governmental party to accord reasonable safeguards for the confidentiality of information provided to it by a TNC that contained confidential business information or legitimate business secrets (paragraph 51). Such information could be obtained in the course of negotiating an investment agreement.

In certain model BITs, general non-derogation provisions seek to protect rights acquired by an investor under a State contract. For example, Article 16 of the 2004 United States model BIT reads as follows:

> "This Treaty shall not derogate from any of the following that entitle covered investments to treatment more favourable than that accorded by this Treaty:
> […]
> 3. obligations assumed by a Party, including those contained in an investment authorization or an investment agreement" (See also 1998 United States model BIT, Article XI; Burundi model BIT, Article 7.1).

A further area of protection that has been considered in IIAs concerns the provision of insurance against risks of loss due to breach of contract on the part of the host country government. Thus, the 1985 MIGA Convention (Article 11(a)(iii)) includes, among the risks it covers:

> "any repudiation by breach by the host government of a contract with the holder of a guarantee, when (a) the holder of a guarantee does not have recourse to a judicial or arbitral forum to determine the claim of repudiation or breach, or (b) a decision by such forum is not rendered within such reasonable period of time as shall be prescribed in the contracts of guarantee pursuant to the Agency's regulations, or (c) such a decision cannot be enforced".

This provision is echoed, in substantially the same terms, by Article19(2)(c) of the 1992 Articles of Agreement of the Islamic Corporation for the Insurance of Investment and Export Credit. In a similar vein, the 1971 Convention Establishing the Inter-Arab Investment Guarantee Corporation covers, by Article 18(1)(a):

> "[m]easures taken by the public authorities in the host country, either directly or through an agency, whereby the investor is deprived of his substantial rights with respect to his investment, and, in particular, confiscatory measures, nationalization, sequestration, expropriation, compulsory seizure, deprivation of a creditor of his rights including the right of assignment, and the imposition of moratoria of unreasonable length."

Although this provision mentions a number of specific acts, it is wide enough to encompass a breach of a State contract where this has the effect of depriving investors of their substantial rights under the agreement.

Finally, certain IIAs contain a clause that requires responsibility for breach of contract on the part of the host country government. This goes beyond the umbrella clause, which requires only observance of obligations but does not expressly deal with the consequences of a breach by the government party. Thus, the 1992 World Bank Guidelines on the Treatment of Foreign Direct Investment state that the rules applicable to the expropriation of foreign private investment will apply "with respect to the conditions under which a State may unilaterally terminate, amend or otherwise disclaim liability under a contract with a foreign private investor for other than commercial reasons, i.e., where the State acts as a sovereign and not as a contracting party" (paragraph 11 of Section IV). Compensation due to the investor in such cases is to be determined in the light of the rules prescribed by the Guidelines in paragraphs 2 to 9 of Section IV. On the other hand, liability for repudiation of a contract for commercial reasons, that is where the State acts as a contracting party, is determined under the applicable law of the contract.

Article 10 of the 1980 Unified Agreement for the Investment of Arab Capital in the Arab States also requires the compensation of an Arab investor for damages sustained due to a number of actions on the part of the State or one of its public or local authorities or institutions. These include: the undermining of rights or guarantees by reason of a decision by a competent authority; breach of international obligations arising out of this Agreement; preventing the execution of an enforceable judgment that has direct connection with the investment; and causing damage to an Arab investor "in any other manner, whether by deed or prevention, by contravening the legal provisions in force within the State in which the investment is made".

D. Development of substantive regimes for State contracts in IIAs

The 1999 Agreement between Azerbaijan, Georgia and Turkey Relating to the Baku-Tiblisi-Ceyhan Main Export Pipeline is also of note in that it contains a number of substantive commitments as to the applicable regime under which the MEP Project is to take place, including the use of security forces to ensure the safety and security of project personnel, applicable technical, safety and environmental standards, and the applicable taxation regime. It is, thus, an international agreement that affects the content and operation of the specific State contracts and other binding commitments made between the consortium of investors and the three host countries.

However, this agreement is a special instance of a particular regime related to a specific major investment project. Most IIAs do not contain such specific substantive provisions that delineate the scope of the commitments that the government party has to include in the terms of the State contract. It should be borne in mind, however, that the General Agreement on Trade in Services (GATS) can have implications for agreements between private service providers and host country governments. Where these are to be put into effect through a Mode 3 (commercial presence) method of supply, such an agreement would be an investment agreement based on a State contract. Equally, a number of recent free trade agreements contain extensive provisions on the procedures to be followed in relation to government procurement contracts. Such provisions can be found, for example, in the United States-Singapore (Chapter 13)[20], the Chile-United States (Chapter 9)[21], the Chile-European Union (Title IV of Part IV)[22], the Chile-Republic of Korea (Part IV)[23], and the Australia-Singapore free trade agreement

(Section 06).[24] They are based on the provisions of the 1994 WTO plurilateral Agreement on Government Procurement. In addition, some free trade agreements signed by Turkey contain commitments to the applicability of the MFN principle in government procurement.[25]

Notes

[1] Unless otherwise indicated, the texts of the BITs and other agreements and instruments mentioned in this paper may be found in UNCTAD's on-line databases on BITs or international investment instruments (www.unctad.org/iia).

[2] See also Article I(3)(e) of the 1987 ASEAN Agreement for the Promotion and Protection of Investments, which reads as follows: “business concessions conferred by law or under contract, including concessions to search for, cultivate, extract or exploit natural resources.” This provision captures primary industries, including plantations as well as natural resources.

[3] The concession, however, denotes a right that is within the power of the government to confer rather than a negotiated term.

[4] 1989 BIT between Germany and Guyana (Article 1.1(e)).

[5] Such a provision would be: “rights, conferred by law or under contract, to undertake any economic and commercial activity, including any rights to search for, cultivate, extract or exploit natural resources” (Article 1(f)(vi) of the 1995 BIT between Canada and the Philippines).

[6] This formulation can be found in a number of United States BITs. See, for example, Article I(d)(iii) of the 1998 Bolivia-United States BIT.

[7] For a similar provision, see the 2004 Canada model BIT, Article 1(X) (on the definition of “investment”).

[8] For examples of this approach, see Article 8(1) of the 1991 Argentina-France BIT or Article 9 of the 1994 Lithuania-Netherlands BIT.

[9] Dolzer and Stevens leave the matter unclear in their short reference to the issue. Their discussion opens with the statement: "These provisions seek to ensure that each Party to the treaty will respect specific undertakings towards nationals of the other Party" (Dolzer and Stevens, 1995, p. 81).

[10] Decision on Objections to Jurisdiction, 6 August 2003.

[11] See paras. 165-170 of the Award.

[12] Para. 168 of the Award.

[13] Decision on Objections to Jurisdiction, 29 January 2004.

[14] On the issue of waiver of international jurisdiction over investment disputes through a dispute resolution provision in a state contract, see further Spiermann (2004).

[15] See further on the question of whether an umbrella clause can turn a breach of contract into a breach of the IIA: Dolzer and Stevens, 1995; Karl, 1996; Schreuer, 2004; Schwebel, 1994; Sinclair, 2004; Vandevelde, 1992, p. 78; Wälde, forthcoming. An analysis of the origin, as well as original and changing context of the umbrella clause suggests that it was not intended to elevate all sorts of commercial and contract law disputes to the level of international law and the jurisdiction of a treaty-based tribunal, but rather is intended to capture the reliance on (probably mainly abusive reliance) government powers and prerogatives to allow a government to escape from its own contractual commitments. It is therefore in the historical context rather a specific sub-set of the expropriation discipline that, before umbrella clauses were used and where they are not used, is applied to cover cases of governments using their sovereign powers to escape from contractual commitments.

[16] On the renegotiation of international investment contracts, see Kolo and Wälde, 2000; Berger, 2003.

[17] Agreement among the Azerbaijan Republic, Georgia and the Republic of Turkey Relating to the Transportation of Petroleum via the Territories of the Azerbaijan Republic, Georgia and the Republic of Turkey through the Baku-Tbilisi-Ceyhan Main Export Pipeline. For the text see http://www.caspiandevelopmentandexport.com/Downloads/BTC/Eng/agmt4/agmt4.PDF.

[18] See for a statement of this position Sornarajah, 2000, pp. 50-51. For an alternative perspective, based on a survey of past treaty practice, see Ndi and Wälde, 1996.

[19] Defined as "each Person that is a party to a Host Government Agreement (other than the Government of any of the respective States in the capacity of a host government counterparty to any such Agreement), and any operating company, branch, office, permanent establishment, affiliate, nominee, agent or representative of such Person, and any successor or assignee of any of the foregoing in respect of the MEP Project"(Article I).

[20] For the text of the Agreement see http://www.mti.gov.sg/public/FTA/frm_FTA_Default.asp?sid=36.

[21] For the text of the Agreement see http://www.sice.oas.org/Trade/chiusa_e/chiusaind_e.asp.

[22] For the text of the Agreement see http://www.sice.oas.org/Trade/chieu_e/cheuin_e.asp.

[23] For the text of the Agreement see http://www.sice.oas.org/Trade/Chi-SKorea_e/ChiKoreaind_e.asp.

[24] For the text of the Agreement see http://www.dfat.gov.au/trade/negotiations/safta/index.html.

[25] See, for example, the Lithuania-Turkey FTA (Article 28), or Croatia-Turkey FTA (Article 28).

SECTION III
INTERACTION WITH OTHER ISSUES AND CONCEPTS

If included in the coverage of an IIA, the issue of State contracts interacts with a significant number of other issues in IIAs (table 1). Apart from issues of scope and definition and dispute settlement – which, as noted in section II, are the most important provisions that deal directly with State contracts – the substantive standards of treatment all have a strong bearing on such contracts, given that the manner in which a private party is treated should comply with those standards.

The substantive content of State contracts is based on national economic laws and policies, which may also be the subject of obligations under IIAs. Thus, there may be overlap with IIA provisions on taxation, host country operational measures, transfer of funds, technology transfer and the taking of property. Furthermore, State contracts may raise issues concerning the environmental protection, employment and social responsibility obligations of a private investor party. As with purely economic issues, such social matters are usually dealt with under the applicable national laws and policies. Given the nature of current practice, social issues are unlikely to be covered directly by an IIA, though this may well be the case in some agreements. On the other hand, the State party to a contract may be obliged to ensure that the terms of that contract are consistent with its international obligations in these areas, as may be provided for in specialized international instruments.

Issues of admission and establishment may be of more limited relevance, as a contract with the host country forms the basis of the admission decision. Thus, where a government concludes an investment contract with a foreign investor, admission based on that contract usually is automatic. Indeed, it can be expected that the State party to the contract is obliged to facilitate the granting of all relevant licenses, permits and authorizations necessary for an investment to be properly approved in accordance with national laws and regulations. Failure to do so may amount to a breach of the investment contract.[1]

Table III.1. Interaction across issues and concepts

Issues	State contracts
Admission and establishment	+
Competition	++
Dispute settlement: investor-State	++
Dispute settlement: State-State	+
Employment	+
Environment	+
Fair and equitable treatment	++
Home country measures	0
Host country operational measures	++
Illicit payment	++
Incentives	+
Investment-related trade measures	0
MFN treatment	++
National treatment	++
Scope and definition	++
Social responsibility	+
Taking of property	++
Taxation	+
Transfer of funds	+
Transfer of technology	+
Transfer pricing	+
Transparency	+

Source: UNCTAD.
Key: 0 = negligible or no interaction.
\+ = moderate interaction.
++ = extensive interaction.

- **Competition.** Competition provisions can apply to a State contract where an IIA covers both private and public entities in the investment process and contractual rights are included in the definition of protected investment under the agreement in question.

- **Dispute settlement: investor-State**. As shown in section II, the scope of the investor-State dispute settlement provision is a key issue when determining the extent of protection that an IIA can give to the private party to a State contract. The availability of such dispute settlement mechanisms for disputes arising out of a State contract can be assured where the scope and definition clause covers contractual obligations and there are no limitations against such disputes in the dispute settlement clause. Such protection can be reinforced through the inclusion of an umbrella clause in an IIA. However, the issue of the availability of international dispute settlement for breaches of State contracts has caused considerable controversy in cases in which a State contract contains a forum selection clause that refers disputes exclusively to domestic courts and tribunals. In such cases, it is unclear whether the arbitration clause in an IIA is available to investors, given that the latter have apparently consented, under the terms of the State contract, to waive their rights to international dispute settlement under the IIA. Much depends on the particular wording of the forum selection clause in the State contract,[2] as well as in the umbrella clause of the IIA that may provide for the application of "other obligations to the extent that they are more favourable" or to the contrary, provide that "in case of conflict, the provisions of the State contract will apply", as, e.g. in article 9.2 of the 1996 Italy-Jordan BIT. In addition the Energy Charter Treaty, Article 26.3c in connection with Annex IA, allows contracting parties that do not accept international arbitration under this Treaty with regard to State contracts, to exclude this on an individual basis (see also UNCTAD, 2003b).

- **Fair and equitable treatment.** This general standard of treatment may interact with State contracts to the extent that it may impose an obligation on the host country to act in good faith towards the foreign investor party to a contract and to observe general standards of good governance in this relationship. Where the standard is linked to international law in the IIA, it may introduce an additional duty to comply with the international minimum standard of treatment as interpreted in State practice and in relevant international arbitral awards. This does not require treatment additional to that needed to meet the international minimum standard.[3] On the other hand, given the controversy surrounding the application of the international minimum standard to State contracts, as described in the Introduction, the reference to this standard could be seen as a significant inroad into the host country's right to regulate. In addition, there remains considerable controversy as to the relationship between breaches of a State contract and breaches of substantive provisions of an IIA. For example, it may not always be certain that a breach of contract amounts to a breach of the fair and equitable treatment standard as defined in an IIA or, indeed, whether it amounts to a regulatory taking as discussed below. This has been an issue in recent NAFTA arbitrations.[4] A further issue that arises is how far the principle of fair and equitable treatment can be used to introduce comparative administrative law analogies with the principle of legitimate expectations in the treatment of State contracts.[5] Several recent arbitral awards have relied on the standard of legitimate expectations (or "detrimental reliance", "estoppel", "*venire contra factum proprium*") as a standard of customary international law that also gives specific content to the "fair and equitable" investment discipline.[6]

- **Host country operational measures.** A diversity of measures can be taken by host States to ensure that a foreign investment contract incorporates certain requirements on the part of an investor that contain a public interest element, such as, for example, minimum employment requirements (UNCTAD, 2001a). In the context of State contracts concerning foreign investment, such requirements become either express or implied terms of the contract. IIAs may contain a clause that prohibits, or limits, the imposition of performance requirements. Thus, where the host country is a member of the WTO, such requirements have to be consistent with the TRIMs Agreement (UNCTAD, 2001a). NAFTA Article 1106 (1), for example, goes further and prohibits certain performance requirements not covered by the TRIMs Agreement. Such provisions negate the possibility of the inclusion of any clause relating to performance requirements in foreign investment contracts that are inconsistent with the host country's treaty commitments in this regard. In this sense, IIA provisions controlling the use of performance requirements limit the host country's freedom to impose performance requirements on investors through the terms of a State contract.

- **Illicit payments.** Prohibitions on illicit payments in international agreements have the effect of requiring the host country to control such practices through criminal law, and to prohibit such practices in relation to international business transactions, including State contracts. Thus, a good governance standard is introduced into the negotiation, conclusion and operation of State contracts (UNCTAD, 2001b).

- **MFN treatment.** In essence, a host country is free to choose with which foreign investor it concludes a foreign investment agreement. On the other hand, where a major investment project is put out to competitive tender, the MFN obligation requires that this process is carried out without discrimination between competing bidders from different countries. Accordingly, rules relating to government procurement may contain an MFN requirement. However, most recent agreements containing disciplines on government procurement do not have an MFN clause, but are restricted to national treatment protection, given the bilateral nature of the commitments involved. On the other hand, if a host country frequently concludes State contracts based on a settled practice arising out of its national laws and policies, then a failure to follow these established practices in a particular case could raise MFN compatibility issues. This may require the host country to show that the case in question is not in "like circumstances" to other cases and therefore merits a departure from usual practice.

- **National treatment.** This standard ensures that foreign investors are not discriminated against in the process of concluding and operating State contracts as compared to domestic investors. Again issues of contractual freedom arise in that a host country may wish to offer more favourable treatment to domestic investors for - policy reasons it regards legitimate. In such cases, an exception to national treatment may be required. In relation to government procurement, recent free trade agreements and the WTO Government Procurement Agreement all contain a national treatment provision.

- **Scope and definition.** The strong significance of this issue to State contracts has already been discussed in some detail in section II.

- **Taking of property.** This is the most difficult provision to deal with when considering the situation from the theoretical perspective of State contracts. In the old customary international law, the issue as to whether the violation of a foreign investment contract through governmental interference gave *per se* rise to State responsibility was a contested issue. Today, the expropriation provision in an IIA may be drafted to cover both direct and indirect expropriation as well as acts tantamount to an expropriation. This provision usually requires that a lawful expropriation must be for a public purpose. It requires the payment of full compensation, even where the requirement of public purpose is satisfied.[7] The difficulty in determining compensation has become apparent in recent arbitral jurisprudence in relation to regulatory takings (UNCTAD, 2003a, chapter IV.C; Wälde and Kolo, 2001). More recent IIAs address this concern. Thus, the 2003 free trade agreement between Singapore and the United States contains an exchange of letters that sets out an understanding covering the matter of regulatory takings.[8] Respective letters state that:

> "[e]xcept in rare instances, non-discriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations" (para. 4(b)).

A similar technique is used in the 2003 free trade agreement between Chile and the United States (see Annex 10-D).[9] Such provisions may be seen as protecting a degree of regulatory discretion that may be particularly important in areas where FDI is undertaken through the means of a State contract.

Notes

[1] This issue has recently been treated in the following arbitral awards: MTD v. Chile (2004); Tecmed v. Mexico (2003). Available at Hwww.worldbank,org/icsidH and www.naftaclaims.com.

[2] On this issue see further Spiermann (2004).

[3] See *Pope & Talbot Inc. v. Canada*, Award on Damages, 31 May 2002.

[4] See Azanian v Mexico (1999) and UNCTAD, 2003a, at pp.113 and 117.

[5] See Occidental v Ecuador, LCIA Case No. UN3467, 1 July 2004.

[6] MTD v. Chile, 2004; Occidental v. Ecuador, 2004; CME V. Czech Republic, 2003; 42 ILM 811; Tecmed v. Mexico, 2004; Metalclad v. Mexico, 2000 - available at www.worldbank.org/icsid and www.naftaclaims.com. The issue is being considered at present in other BIT-based arbitration cases. "Legitimate expectations" is a principle of international law, but also in developed countries' administrative law and in the law applied by the WTO and the EU to provide external disciplines over domestic administrative action. It usually involves a balancing between the legitimate expectation of investors with public policy objectives in order not to lose the flexibility for future policies.

[7] There are widely diverging arbitral awards with respect to damages for cancellation of contracts. In some agreements, the investor has obtained compensation to include both past expenditures and the net present value of expected future cash flows (CME v. Czech Republic, 2003; Karaha Bodas v. Indonesia, 1999). In other cases, in particular where a contract had as yet not been implemented, compensation was calculated to include only expenditures spent so far. In the first Energy Charter Treaty case, partial compensation was awarded for under-payment of contractual charges due, together with an order to pay all contractually due future tariff charges (Wälde and Hober, forthcoming).

[8] For the text of the Agreement see http://www.mti.gov.sg/public/FTA/ frm_FTA_Default.asp?sid=36.

[9] For the text of the Agreement see http://www.sice.oas.org/Trade/chiusa_e/ chiusaind_e.asp.

CONCLUSION: ECONOMIC AND DEVELOPMENT IMPLICATIONS AND POLICY OPTIONS

State contracts have played a major role in the FDI process, especially in developing countries that are dependent upon the exploitation of natural resources for their economic welfare. As such, they represent an important tool of development policy. Without the use of such contracts significant opportunities for the introduction of FDI into strategic national industries may well have been lost.

On the other hand, such contracts, when used in relation to FDI, have themselves created issues of concern to the development policies of host countries. In particular, earlier types of concession agreements, which included stabilization, choice of external law and internationalized arbitration clauses, began to be seen as inconsistent with the aims of host country development policies and with the right to regulate major investment projects. Although such difficulties led to major investment disputes in the second half of the 20th century, they also gave rise to newer types of provisions that allow for the regular review of long-term investment contracts (Muchlinski, 1999, ch. 14). Indeed, if State contracts are to act as a useful device for investment and development, they need to allow for a balance between the legitimate commercial expectations of an investor party and the right of a host country party to oversee the evolution of the resulting relationship in a manner that is consistent with national development policies. To the extent that IIAs can do so, they may be seen as a means of furthering that balancing process, particularly where they are geared towards flexibility in their provisions, a flexibility that can allow for a development-friendly approach to FDI policy, including policy towards State contracts.

Against this background a number of options present themselves for the treatment of State contracts in IIAs:

Option 1: the exclusion of State contracts from IIAs

Such an approach may be attractive to countries that want to retain complete freedom of action in relation to State contracts and to avoid, as far as possible, the application of international investment protection standards to such contracts. This can be achieved through the express exclusion of such contracts from the scope of an IIA and/or exclusion of references to breaches of contractual obligations as protected assets in the definition of investment. In addition, it may be made clear in the dispute settlement clause that it does not apply to disputes arising out of State contracts. Furthermore, the agreement would not have an umbrella clause.

The effect of such an approach might be to signal caution on the part of foreign investors as to the advisability of entering into State contracts with the host country in question. However, much would depend on the capacity of the host country's legal system to offer full protection and security for the rights of an investor under the State contract to which it has become a party. If such protection is available, the added protection of IIA provisions may not be necessary to attract investors, and for them to have confidence in the security of their contractual rights with the government of the host country.

Option 2: limited protection for State contracts under IIAs

Where a host country wishes to extend protection under international commitments to investors that conclude State contracts with the government of that country, but wishes to maintain considerable discretion to regulate the resulting investment relationship, it may be possible to offer a limited degree of protection for the investor under the IIA. This may be achieved through a combination of any one or more of the following strategies:

- A positive listing of the types of State contracts that are covered by an IIA, allowing for the exclusion from the operation of the IIA of those not listed; or the negative listing of those types of State contracts that are excluded from the operation of the agreement, allowing for its application to those types of State contract that are not listed. Positive listing may be preferred by countries that do not wish to commit to a general application of the IIA to State contracts, but that wish to allow for its protection to specified classes of agreement, while negative listing may be attractive for countries that are committed to the extension of IIAs to State contracts, save for certain defined categories of excluded agreements.
- A restrictive definition of the kinds of contractual breaches that can attract the protection of an agreement with, for example, exceptions for public policy discretions to terminate the contract for public policy reasons.
- The restriction of dispute settlement clauses to those types of disputes arising out of State contracts that a host country is willing to subject to international dispute settlement mechanisms under the IIA.
- The possible exclusion of certain investor protection standards from particular types of State contracts, for example, by industry or size of investment.
- Inclusion of national security and general public policy exceptions into an IIA. The presence of such a clause may, of itself, be sufficient to protect regulatory discretion even in an otherwise broadly protective treaty regime for State contracts.
- The exclusion of an umbrella clause.

Such an approach may engender a cautious response from investors. On the other hand, it would show a willingness on the part of the host country to limit its regulatory discretion in specific areas in which it wishes to encourage FDI through State contracts, while retaining it in those areas that are more policy sensitive and that require greater regulatory discretion based on national laws and regulations.

Option 3: full protection of State contracts

Full protection for investors entering into State contracts can be achieved through the following:

- An unlimited and unconditional definition of investment that includes any contractual obligation owed to the investor by the host country.
- A similarly unlimited and unconditional dispute settlement clause that applies to disputes arising out of State contracts.
- The reinforcement of protection under an IIA of State contracts through the inclusion of an umbrella clause.
- The introduction of a stabilization commitment into an IIA that acts to reinforce the stabilization clause in the State contract.

In addition, where a country wishes to accept international disciplines concerning the substantive content of certain types of State contract, it may conclude provisions containing such disciplines. These then inform the content of national policy and of specific contracts concluded with foreign investors.

* * *

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