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## **The Robert E. Hudec Article on Global Trade**

### **Enabling Private Ordering: Function, Scope and Effect of Umbrella Clauses in International Investment Treaties**

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This article deals with the function, scope and effect of umbrella clauses in international investment treaties. It proposes to analyze umbrella clauses not from the perspective of the traditional dualist framework that contrasts breaches of contracts and breaches of treaties, but instead develops the function of umbrella clauses against the background of an economic analysis of the relations between foreign investors and host States. The dualist approach, it is argued, fails to grasp the economic objective of investor-State cooperation to achieve cost-efficient bargains by attenuating the State's capacity to make credible and enforceable commitments and thus increases the costs of contracting with a sovereign. This article understands umbrella clauses as breaking with the dualist framework and its limited protection of contracts under customary international law. It argues that the function of the clauses consists of

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stabilizing investor-State relations by opening recourse to dispute settlement by arbitral tribunals for breaches of specific and individual promises made by the State vis-à-vis investors.

Umbrella clauses, in this view, allow investors to bring any claim for the breach of an investment-related promise made by the host State under the jurisdiction of a treaty-based tribunal. Umbrella clauses thereby enable "private ordering" in investor-State relations by preventing host States from acting opportunistically in reneging on their initial promises. It applies to host State breaches of a governmental nature as well as breaches of a purely commercial character that offset the original investor-State bargain. By enabling the enforcement of host State promises, umbrella clauses reinforce the principle of *pacta sunt servanda* as a fundamental basis for investor-State contracts. The clauses do not, however, address issues, which often arise in long-term investment relations, relating to contingencies, nor do they override the State's police power to regulate investor-State contracts in the public interest that is recognized under customary international law.

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## I. INTRODUCTION: "SPIRITS THAT I'VE CITED—MY COMMANDS IGNORE . . .”?

Many investment treaties contain clauses providing that “[e]ach Contracting Party shall observe any other obligation it has assumed with regard to investments by nationals or companies of the other Contracting Party in its territory.”<sup>1</sup> Such clauses are most commonly designated as “umbrella clauses”<sup>2</sup> because they create a separate obligation under the investment treaty, requiring the Contracting Parties to observe obligations the host State has assumed in its relations with nationals of the other Contracting Party. Until recently, little debate existed as to the construction, the scope of application, and the general effect of such clauses. Commentators, rather unanimously, opined that

[t]hese provisions seek to ensure that each Party to the treaty will respect specific undertakings towards nationals of the other Party. The provision is of particular importance because it protects the investor's contractual rights against any interference which might be caused by either a simple breach of contract or by administrative or legislative acts, and because it is not entirely clear under general international law whether such measures constitute breaches of an international

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1. German-Argentine BIT, F.R.G.-Arg., Apr. 9, 1991, BGBl. II 1993, 1244 (“Artikel 2 (1). Jede Vertragspartei wird in ihrem Hoheitsgebiet Kapitalanlagen von Staatsangehörigen oder Gesellschaften der anderen Vertragspartei fördern und diese Kapitalanlagen in Übereinstimmung mit ihren Rechtsvorschriften zulassen.”). It is estimated that approximately 40% of bilateral investment treaties contain umbrella clauses. See Judith Gill et al., *Contractual Claims and Bilateral Investment Treaties*, 21 J. INT'L ARB. 397, 403 n.31 (2004).

2. Other designations include “elevator clauses,” “parallel effect clauses,” or “mirror effect clauses.” See Anthony C. Sinclair, *The Origins of the Umbrella Clause in the International Law of Investment Protection*, 20 ARB. INT'L 411, 412–13 (2004), for a discussion of the different designations and the origin of the term “umbrella clause.”

obligation.<sup>3</sup>

One should have thus expected little difficulty in the application of umbrella clauses by arbitral tribunals. In practice, however, their application has turned into one of the most contentious issues of international investment law.<sup>4</sup>

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3. RUDOLF DOLZER & MARGRETE STEVENS, *BILATERAL INVESTMENT TREATIES* 81–82 (1995); accord GEORGES R. DELAUME, *TRANSNATIONAL CONTRACTS—APPLICABLE LAW AND SETTLEMENT OF DISPUTES* (1993); KENNETH J. VANDELDE, *UNITED STATES INVESTMENT TREATIES* 81 *et seq.* (1992); OPPENHEIM'S *INTERNATIONAL LAW* § 408 (Robert Y. Jennings & Arthur D. Watts eds., 9th ed. 1992); U.N. CONFERENCE ON TRADE & DEV., *BILATERAL INVESTMENT TREATIES IN THE MID-1990'S* 56 (1998); U.N. CONFERENCE ON TRADE & DEV., *BILATERAL INVESTMENT TREATIES IN THE MID-1990'S* 56 (1998); Derek W. Bowett, *State Contracts with Aliens: Contemporary Developments in Compensation for Termination or Breach of Contract of International Law*, 59 *BRIT. Y.B. INT'L L.* 49 (1988); Joachim Karl, *The Promotion and Protection of German Foreign Investment Abroad*, 11 *ICSID REV.—FOREIGN INV. L.J.* 1, 23 (1996); Marian Nash Leich, *Contemporary Practice of the United States Relating to International Law*, 84 *AM. J. INT'L L.* 885, 898 (1990); F. A. Mann, *British Treaties for the Promotion and Protection of Investments*, 52 *BRIT. Y.B. INT'L L.* 242, 246 (1981); François Rigaux, *Les situations juridiques individuelles dans un système de relativité générale*, 213 *RECUEIL DES COURS* 1, 230 (1989–I); Ibrahim F. I. Shihata, *Applicable Law in International Arbitration: Specific Aspects in Case of the Involvement of State-Parties*, in 2 *THE WORLD BANK IN A CHANGING WORLD: SELECTED ESSAYS AND LECTURES* 595, 601 (Ibrahim F. I. Shihata & James D. Wolfensohn eds., 1995); Prosper Weil, *Problèmes relatifs aux contrats passés entre un Etat et un particulier*, 128 *RECUEIL DES COURS* 95, 130 (1969–III).

4. For the more recent debate surrounding the application of the umbrella clause, see Stanimir A. Alexandrov, *Breaches of Contract and Breaches of Treaty*, 5 *J. WORLD INV. & TRADE* 555 (2004); John P. Gaffney & James L. Loftis, *The "Effective Ordinary Meaning" of BITs and the Jurisdiction of Treaty-Based Tribunals to Hear Contract Claims*, 8 *J. WORLD INV. & TRADE* 5 (2007); Walid Ben Hamida, *La clause relative au respect des engagements dans les traités d'investissement*, in *NOUVEAUX DEVELOPPEMENTS DANS LE CONTENTIEUX ARBITRAL TRANSNATIONAL RELATIF A L'INVESTISSEMENT INTERNATIONAL* 53 (Charles Leben ed., 2006); Bjørn Kunoy, *Singing in the Rain – Developments in the Interpretation of Umbrella Clauses*, 7 *J. WORLD INV. & TRADE* 275 (2006); Hein-Jürgen Schramke, *The Interpretation of Umbrella Clauses in Bilateral Investment Treaties*, 4 *TRANSNAT'L DISP. MGMT.* (May 2007); Christoph Schreuer, *Travelling the BIT Route: Of Waiting Period, Umbrella Clauses and Forks in the Road*, 5 *J. WORLD INV. & TRADE* 231, 249–55 (2004); Sinclair, *supra* note 2; Thomas W. Wälde, *Contract Claims under the Energy Charter's Umbrella Clause: Original Intentions versus Emerging Jurisprudence*, in *INVESTMENT ARBITRATION AND THE ENERGY CHARTER TREATY* 205 (Clarisse Ribeiro ed., 2006); Thomas W. Wälde, *The "Umbrella Clause" in Investment Arbitration: A Comment on Original Intentions and Recent Cases*, 6 *J. WORLD INV. & TRADE* 183 (2005); André von Walter, *Die Reichweite von Schirmklauseln in Investitionsschutzabkommen nach der jüngsten ICSID-Sprachpraxis*, 52 *RECHT DER INTERNATIONALEN WIRTSCHAFT* 815 (2006); Jarrod Wong, *Umbrella Clauses in Bilateral Investment Treaties: Of Breaches of Contract, Treaty Violations, and the Divide between Developing and Developed Countries in Foreign Investment Disputes*, 14 *GEO. MASON L. REV.* 135 (2006); Vlad Zolia, *Effect*

Triggered by the incompatible construction of comparable clauses in the Swiss-Pakistani and the Swiss-Philippine bilateral investment treaties (BITs) by two ICSID tribunals,<sup>5</sup> contrary views developed on the function of umbrella clauses in investment treaties. One line of jurisprudence supports a broad application of umbrella clauses allowing foreign investors to use investment treaty arbitration in order to seek relief for any breach of an investment-related promise by the host State, independent of the nature of the obligations and independent of the nature of the breach, and thus relates to commercial as well as sovereign conduct of host States.<sup>6</sup> In this view, umbrella clauses go beyond customary international law by permitting foreign investors to bring claims for the breach of host State promises as a violation of the umbrella clause under the respective investment treaty without being restricted to targeting expropriatory, discriminatory or arbitrary conduct or, more generally, breaches of a sovereign nature. Umbrella clauses thus bridge the traditional distinction between municipal and international law, between contracts and treaties, by providing an international law remedy in case of any, even if "simple" or commercial, breach of an investor-State contract.

The competing approach attributes a narrower function to umbrella clauses in only restricting a State's sovereign conduct. In this view, the breach of an umbrella clause requires the breach of an investor-State contract resulting from a sovereign

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*and Purpose of "Umbrella Clauses" in Bilateral Investment Treaties: Unresolved Issues*, 2 *TRANSNAT'L DISP. MGMT.* (2004); Katia Yannaca-Small, *Interpretation of the Umbrella Clause in Investment Agreements* (OECD Working Papers on International Investment 2006/3, 2006), available at <http://www.oecd.org/dataoecd/3/20/37579220.pdf>.

5. *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, ICSID (W. Bank) Case No. ARB/02/6, Decision on Objections to Jurisdiction, paras. 113–28 (Jan. 29, 2004); *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, ICSID (W. Bank) Case No. ARB/01/13, Decision on Objections to Jurisdiction, paras. 163–73 (Aug. 6, 2003). All arbitral awards, unless expressly stated otherwise, can be downloaded via <http://ita.law.uvic.ca>.

6. Supporting the broader view, see *CMS Gas Transmission Company v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/01/8, Decision on Annulment, paras. 89–95 (Sept. 25, 2007); *Siemens A.G. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/02/8, Award, paras. 204–06 (Feb. 6, 2007); *LG&E Energy Corp. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/02/1, Decision on Liability, paras. 169–75 (Oct. 3, 2006); *Noble Ventures, Inc. v. Romania*, ICSID (W. Bank) Case No. ARB/01/11, Award, paras. 46–62 (Oct. 12, 2005); *SGS v. Philippines*, ICSID Case No. ARB/02/6, at paras. 113–28; *Eureko B.V. v. Republic of Poland*, UNCITRAL, Partial Award, paras. 244–60 (Aug. 19, 2005).

act of the host State.<sup>7</sup> Essentially, this approach views umbrella clauses as a declaratory codification of customary international law that clarifies that rights of an investor under an investor-State contract can form the object of an expropriation and accordingly require compensation in case they are taken.<sup>8</sup> Most importantly, this position excludes breaches of a purely commercial nature and reads the distinction between contract claims and treaty claims into the interpretation of the umbrella clause. This excludes “simple” or commercial breaches of investor-State contracts from its scope of application.

However, not only the function of umbrella clauses has divided arbitral tribunals. Tribunals have also developed divergent views on the scope of protection that umbrella clauses offer, i.e. the question of what kind of host State promises they cover. Some consider umbrella clauses to be limited to the protection of investor-State contracts, while others include specific host State promises in a broader sense.<sup>9</sup> Furthermore, contention exists regarding the effect of umbrella clauses on contractual relations between foreign investors and host States. This concerns the question of how umbrella clauses affect the interplay between the international treaty law that governs the relations between host States and investors’ home States and

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7. See *Sempra Energy Int’l v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/02/16, Award, paras. 305–14 (Sept. 28, 2007); *Pan American Energy LLC, and BP Argentina Exploration Company v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/03/13, and *BP America Production Company, Pan American Sur SRL, Pan American Fuegoína, SRL and Pan American Continental SRL v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/04/8 (consolidated claims), Decision on Preliminary Objections, paras. 100–16 (July 27, 2006); *El Paso Energy Int’l Co. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/03/15, Decision on Jurisdiction, paras. 71–88 (Apr. 27, 2006); *CMS Gas Transmission Company v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/01/8, Award, paras. 296–303 (May 12, 2005); see also *Enron Corporation and Ponderosa Assets L.P. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/01/3, Award, paras. 273–77 (May 22, 2007) (holding that the respondent assumed obligations under the umbrella clause by passing legislation, but not explicitly ruling on what, if any, contractual obligations are covered by the umbrella clause).

8. Cf. Thomas W. Wälde, *Contract Claims under the Energy Charter’s Umbrella Clause: Original Intentions versus Emerging Jurisprudence*, in *INVESTMENT ARBITRATION AND THE ENERGY CHARTER TREATY* 201, 217 (Claude Ribeiro ed., 2006) (“The umbrella clause was not seen as something radically new, but rather as a clarification of the prevalent theory . . . that international law, be it in its customary or treaty-based form, did not allow governments to rely on their specific sovereign powers to undercut long-term contractual arrangements set up to regulate a state-foreign direct investor relationship.”); see also Wälde, “*Umbrella Clause*” in *Investment Arbitration*, *supra* note 4, *passim*.

9. See *infra* Part V.



the municipal law that governs the relations between States and investors.<sup>10</sup> Differences in this respect play out, in particular, regarding the resolution of potential jurisdictional conflicts between the dispute settlement forum provided under the investment treaty and the forum selected in an investor-State contract.<sup>11</sup>

What is uncontested, by contrast, is that umbrella clauses do not apply to contracts between private parties even if one of them is a foreign investor, as it is an obligation between the contracting States to observe *their* obligations vis-à-vis foreign investors.<sup>12</sup> In addition, their wording clarifies that umbrella clauses do not affect the State's regulation of nonexistent, future commitments, but only concern the observance of *existing* commitments. Umbrella clauses do not, therefore, restrict States in the terms and conditions they offer when contracting with foreign investors.<sup>13</sup> Equally, what seems to be common ground among arbitral tribunals is an unease about the potential limitlessness of the clauses' scope if not handled with a restrictive approach to interpretation.<sup>14</sup> Like in Goethe's

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10. See *infra* Part IV.A.

11. See *infra* Part IV.B.

12. DOLZER & STEVENS, *supra* note 3, at 82; Mann, *supra* note 3, at 246. Misplaced, in this context, is *El Paso Energy Int'l Co. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/03/15, Decision on Jurisdiction, para. 84 (Apr. 27, 2006) ("[T]here is no doubt that if the State interferes with contractual rights by a unilateral act, whether these rights stem from a contract entered into by a foreign investor with a private party, a State autonomous entity or the State itself, in such a way that the State's action can be analysed as a violation of the standards of protection embodied in a BIT, the treaty-based arbitration tribunal has jurisdiction over all the claims of the foreign investor, including the claims arising from a violation of its contractual rights.").

13. It is, however, conceivable that the content of contracts that States offer to foreign investors or the procedure in which they are passed violates other investors' rights, such as fair and equitable treatment. See generally Stephan Schill, *Fair and Equitable Treatment under Investment Treaties as an Embodiment of the Rule of Law*, (IILJ Global Administrative Law Series, Working Paper 2006/6), available at <http://www.iilj.org/20066SchillGAL.htm> (noting that the fair and equitable treatment standard is increasingly invoked by arbitral tribunals, but that the standard is vague).

14. See, e.g., *Pan American Energy LLC, and BP Argentina Exploration Co. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/03/13, and *BP America Production Co., Pan American Sur SRL, Pan American Fuego, SRL and Pan American Continental SRL v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/04/8 (consolidated claims), Decision on Preliminary Objections, para. 110 (July 27, 2006) (noting that investors are unlikely to show restraint in bringing claims, so the tribunals should show the appropriate restraint); *El Paso Energy*, ICSID Case No. ARB/03/15, para. 82 (warning of the "far-reaching consequences of a broad interpretation of the so-called umbrella clauses"); *SGS Société Générale de*

*Zauberlehrling*, arbitral tribunals seem to be afraid of the independent lives umbrella clauses could assume once released into uncontrollable freedom: “Spirits that I’ve cited/My commands ignore.”<sup>15</sup>

Certainly, the main reason for this concern is the lack of textual and interpretative guidance provided by investment treaties for alleviating the multiple insecurities surrounding umbrella clauses. In particular, only having regard to the wording of most umbrella clauses, without a conceptual framework of their function, scope, and effect in mind, will hardly solve the difficult interpretative conundrums connected with their implementation and application. Similarly, academic writing only offers glimpses into a more conceptual framework for the function of umbrella clauses. Such writing is particularly scarce in drawing connections between the different interpretations of umbrella clauses and the economic effects these interpretations have on investor-State relations, although investment treaties intend to establish a framework “to protect and to promote foreign investment flows between the contracting State parties.”<sup>16</sup> This objective suggests that investment treaties aim at establishing institutions that govern the relations between the State, the economy, and individual economic actors,<sup>17</sup> and that are conducive to increasing trans-border investment flows and eventually economic growth and development.<sup>18</sup>

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Surveillance S.A. v. Islamic Republic of Pakistan, ICSID (W. Bank) Case No. ARB/01/13, Decision on Objections to Jurisdiction, para. 167 (Aug. 6, 2003) (arguing that a broad interpretation would be too burdensome on contracting parties); see also Gill et al., *supra* note 1, at 405 (commenting that the Tribunal in *SGS v. Pakistan* feared that a broad interpretation of the clause would “potentially open the floodgates” to an unlimited number of reciprocal or unilateral commitments by the host State independent of their legal status in domestic law); Wälde, “*Umbrella Clause*” in *Investment Arbitration*, *supra* note 4, at 215 (discussing arguments for why the Tribunal in *SGS v. Pakistan* feared “opening the floodgates”).

15. JOHANN WOLFGANG VON GOETHE, *Der Zauberlehrling*, in GOETHE, THE LYRICIST 102, 109 (Edwin H. Zeydel trans., The University of North Carolina Press 1955) (1779).

16. See DOLZER & STEVENS, *supra* note 3, at 11–13, 20–25, on the object and purpose of investment treaties and the statements contained in their preambles.

17. See DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE 3 (1990) (stating that institutions are “rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction”). Contracts and dispute settlement mechanisms for their enforcement are institutions in this sense.

18. For a discussion of the connection between institutions and growth, see THE LAW AND ECONOMICS OF DEVELOPMENT (Edgardo Buscaglia et al. eds., Jai Press 1997); Jean-Philippe Platteau, *Institutions, Social Norms, and Economic*

Consequently, this article uses an economic framework to explain the function of umbrella clauses. It argues that they

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*Development*, in 1 FUNDAMENTALS OF DEVELOPMENT ECONOMICS (Kaushik Basu ed., Harwood Academic Publishers 2000). For a more recent discussion of the connection between institutions and growth, see Daron Acemoglu et al., *Institutions as the Fundamental Cause of Long-Run Growth*, in 1A HANDBOOK OF ECONOMIC GROWTH 385 (Philippe Aghion & Steven N. Durlauf eds., 2005) ; Agnès Bénassy-Quéré et al., *Institutional Determinants of Foreign Direct Investment*, 30 WORLD ECON. 764 (2007); Dani Rodrik et al., *Institutions Rule: The Primacy of Institutions Over Geography and Integration in Economic Development*, 9 J. ECON. GROWTH 131 (2004). For criticism of the causality between political institutions and growth, see Edward L. Glaeser et al., *Do Institutions Cause Growth?*, 9 J. ECON. GROWTH 271 (2004). *But see* Abdur Chowdhury & George Mavrotas, *FDI and Growth: What Causes What?*, 29 WORLD ECON. 9 (2006); Henrik Hansen & John Rand, *On the Causal Links between FDI and Growth in Developing Countries*, 29 WORLD ECON. 21 (2006) (both suggesting bi-directional causality between foreign direct investment and growth).

The causality between the conclusion of investment treaties and the actual flow of foreign investment is still another issue. Initially, there was quite some skepticism about whether BITs actually have the effect of stimulating investment flows between the contracting State parties. Two earlier studies in particular found no significantly positive relationship between the conclusion of BITs and an increase in investment inflows into the country. Emma Aisbett, *Bilateral Investment Treaties and Foreign Direct Investment: Correlation versus Causation* (May 5, 2008), [http://www.economics.smu.edu.sg/events/Paper/emma\\_aisbett.pdf](http://www.economics.smu.edu.sg/events/Paper/emma_aisbett.pdf); Mary Hallward-Driemeier, *Do Bilateral Investment Treaties Attract FDI? Only a Bit...And They Could Bite* (World Bank Policy Research, Working Paper Series No. WPS 3121, 2003); Jennifer Tobin & Susan Rose-Ackerman, *Foreign Direct Investment and the Business Environment in Developing Countries: the Impact of Bilateral Investment Treaties* (Yale Law & Economics Working Paper Series., Research Paper No. 293, May 2, 2005) available for download at <http://ssrn.com/abstract=557121> (finding no positive relationship). The bulk of the studies, however, including a more recent one by Tobin and Rose-Ackermann, find a positive relationship between signing BITs and FDI flows. *See* Jennifer Tobin & Susan Rose-Ackerman, *When BITs Have Some Bite: The Political-Economic Environment for Bilateral Investment Treaties*, in THE FUTURE OF INVESTMENT ARBITRATION (Roger P. Alford & Catherine Rogers eds., forthcoming 2008), available at [http://www.law.yale.edu/documents/pdf/When\\_BITs\\_Have\\_Some\\_Bite.doc](http://www.law.yale.edu/documents/pdf/When_BITs_Have_Some_Bite.doc); *see also* Tim Büthe & Helen V. Milner, *The Politics of Foreign Direct Investment into Developing Countries: Increasing FDI through International Trade Agreements?*, 52 AM. J. POL. SCI. (forthcoming Oct. 2008); Peter Egger & Valeria Merlo, *The Impact of Bilateral Investment Treaties on FDI Dynamics*, 30 WORLD ECON. 1536 (2007); Peter Egger & Michael Pfaffermayr, *The Impact of Bilateral Investment Treaties on Foreign Direct Investment*, 32 J. COMP. ECON. 788 (2004); Kevin P. Gallagher & Melissa B.L. Birch, *Do Investment Agreements Attract Investment? Evidence from Latin America*, 7 J. WORLD INV. & TRADE 961, 969 (2006); Eric Neumayer & Laura Spess, *Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries?*, 33 WORLD DEV. 1567 (2005); Jeswald W. Salacuse & Nicholas P. Sullivan, *Do BITs Really Work?: An Evaluation of Bilateral Investment Treaties and Their Grand Bargain*, 46 HARV. INT'L L. J. 67 (2005); Kim Sokchea, *Bilateral Investment Treaties, Political Risk, and Foreign Direct Investment* (2006), available at <http://ssrn.com/abstract=909760>.

enhance the capacity of host States to make credible and enforceable commitments in their relations with foreign investors by establishing effective, treaty-based dispute settlement and enforcement mechanisms for host State promises. Umbrella clauses allow host States and investors to achieve bargains that are more cost-efficient compared to the investor-State cooperation that takes place outside the realm of effective contract enforcement. This function of umbrella clauses, it is submitted, is not limited to mitigating inequalities between foreign investors and a host State stemming from the sovereign power and prerogatives of the host State, but equally targets the shortcomings in dispute settlement and enforcement in the case of non-sovereign breaches of investor-State contracts by the host State.<sup>19</sup> In accordance with this function, a distinction between interferences of a governmental and those of a commercial character is not adequate. Overall, umbrella clauses are understood to enable and strengthen forms of “private ordering” in investor-State relations, forms that involve the empowerment of investors and States to cooperate and order their interactions based on consensual agreement reached among equals by way of negotiation.<sup>20</sup>

In order to forward this argument, Part II focuses on the limitations the traditional dualist distinction between international and national law imposes on cost-efficient investor-State contracting and cooperation. It outlines the significance of making credible commitments in order to immunize investor-State bargains from opportunistic behavior of the host State and to allow for efficient investor-State cooperation, and submits that this often requires effective enforcement mechanisms through independent third party dispute resolution. However, under both domestic legal systems and the customary international law framework, there are shortcomings in regards to effective enforcement mechanisms for host State promises. Above all, the dualist framework of international law, with its strict distinction between municipal and international law and the distinction between contract claims and treaty claims, attenuates the capacity of the host

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19. Cf. Pierre Mayer, *La neutralisation du pouvoir normatif de l'Etat en matière de contrats d'Etat*, 113 J. DU DROIT INTERNATIONAL 5 (1986) (noting that the normative power of the host State comprises both its function as legislator and judge over the scope of enforceability of the promises it makes).

20. Cf. Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L. J. 950 (1979).

State to make credible commitments to foreign investors and thus constitutes an impediment to cost-efficient investor-State cooperation.

Against this backdrop, Part III submits that umbrella clauses have to be understood as a reaction to the insufficient protection of investor-State contracts by international law and as a departure from a dualist conception that paradigmatically contrasts international relations and investor-State relations. The primary function of the umbrella clause, it is argued, has to be seen in its jurisdictional nature that allows investors to initiate treaty-based arbitration for the breach of promises made by the host State vis-à-vis the investor. By offering enforcement mechanisms on the level of international law, umbrella clauses stabilize the relationship between the host State and foreign investors *ex post* against opportunistic host State behavior. This departure from the dualist conception is, however, not a fundamental breakage with the essence of international law and international dispute resolution as such. Rather, the international law of nations has always, at various times and in different dispute settlement fora, accepted that States could submit claims for the breach of municipal law to international dispute settlement.

Part IV then turns to the effect umbrella clauses have on the substantive relations between investors and host States and the law that governs them. It argues that the clauses, while reinforcing the principle of *pacta sunt servanda*, do not alter the legal nature of the relationship between investor and host State. They do not automatically elevate their relations to be governed by international law, nor do they transform breaches of domestic law into breaches of international law. Umbrella clauses merely open recourse to investment treaty arbitration in order to enforce host State promises governed by whatever, mostly municipal, law the parties to an investor-State contract chose as governing their relations. Equally, umbrella clauses are limited to targeting and sanctioning *opportunistic behavior* of host States, but do not provide solutions to problems arising out of contingencies emerging in investor-State relations. The inclusion of an umbrella clause does, therefore, not exclude exceptions to the sanctity of contracts based on doctrines of change of circumstances, *force majeure*, necessity, or the like under the law governing the relations between investor and State in question, nor does it override the competences of the host State to avail itself of its police power to regulate investor-

State contracts as recognized under customary international law.

Finally, Part V examines the scope of the umbrella clause *ratione materiae* and analyzes the kind of commitments the clauses cover. It argues that umbrella clauses cover contractual as well as such quasi-contractual commitments that can be viewed as a substitute for an investor-State contract, even though they may take the form of unilateral acts by the host State or emanate from its domestic legislation. It is, however, crucial that such promises relate to an investment as defined in the respective investment treaty. This article submits, therefore, that umbrella clauses break with the limited protection of host State promises under international law by establishing the jurisdiction of investment tribunals for any breach of such promises. They are not limited to protecting against expropriatory, discriminatory, or arbitrary conduct, but comprehensively aim at providing an infrastructure that backs up “private ordering” between investors and States.

## II. THE DUALIST FRAMEWORK’S LIMITATIONS TO EFFICIENT INVESTOR-STATE CONTRACTING

Arbitral jurisprudence on the umbrella clause is fundamentally divided between an approach that gives effect to the plain meaning of the clauses and a more restrictive approach that focuses on systemic issues concerning the relationship between municipal and international law, contract claims and treaty claims. The first approach considers that any breach of a promise made by the host State vis-à-vis a foreign investor gives rise to a violation of the umbrella clause and, accordingly, entitles the investor to damages.<sup>21</sup> This approach mainly relies on three arguments. First, it stresses the plain wording of the clauses that in most cases “say clearly, that each Contracting Party shall observe any legal obligation it has assumed, or will in the future assume, with regard to specific investments covered by the BIT.”<sup>22</sup> Second, it stresses the

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21. See cases cited *supra* note 6.

22. *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, ICSID (W. Bank) Case No. ARB/02/6, Decision on Objections to Jurisdiction, para. 115 (Jan. 29, 2004); see also *Noble Ventures, Inc. v. Romania*, ICSID (W. Bank) Case No. ARB/01/11, Award, para. 51 (Oct. 12, 2005); *Siemens A.G. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/02/8, Award, para. 204 (Feb. 6, 2007); *Eureko*, *supra* note 6, para. 246.

principle of effective interpretation of international treaties—a treaty provision has to be given an operative meaning rather than an interpretation that renders it meaningless.<sup>23</sup> Effective interpretation, in this view, requires giving the umbrella clause a scope of application that is different from the scope of application of other investor's rights, such as expropriation or fair and equitable treatment. Finally, this approach invokes the object and purpose of investment treaties in order to support a broad interpretation of umbrella clauses.<sup>24</sup>

The second approach, by contrast, does not deny the importance of treaty interpretation, but stresses a systematic aspect regarding the relationship between international law and municipal law.<sup>25</sup> Instead of focusing primarily on the wording of the clause, the principle of effective interpretation, and the teleology of investment treaties, it starts from the premise of the conceptual and fundamental difference between contracts, governed by municipal law, and international treaties, which are governed by international law.<sup>26</sup> Based on this distinction, the narrower approach emphasizes the disruptive effect that a broad and literal interpretation of umbrella clauses would have on the distinction between international law, as governing the relations between States, and municipal law, as governing the

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23. See *SGS v. Philippines*, ICSID Case No. ARB/02/6, at para. 115; *Noble Ventures*, ICSID Case No. ARB/01/11, at para. 50; *Eureko*, *supra* note 6, paras. 248–249.

24. See *SGS v. Philippines*, ICSID Case No. ARB/02/6, at para. 116; *Noble Ventures*, ICSID Case No. ARB/01/11, at para. 52; *Eureko*, *supra* note 6, paras. 255–57.

25. See *Pan American Energy LLC, and BP Argentina Exploration Co. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/03/13, and *BP America Production Co., Pan American Sur SRL, Pan American Fuego SRL and Pan American Continental SRL v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/04/8 (consolidated claims), Decision on Preliminary Objections, para. 110 (July 27, 2006); *El Paso Energy Int'l Co. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/03/15, Decision on Jurisdiction, para. 82 (Apr. 27, 2006); *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, ICSID (W. Bank) Case No. ARB/01/13, Decision on Objections to Jurisdiction, para. 167 (Aug. 6, 2003).

26. This distinction has been firmly established as a conceptual divide between two different, and in principle independent, legal orders with their proper scope of application and regulation by the mainstream positivist school of international law. See 1 LASSA OPPENHEIM, *INTERNATIONAL LAW* § 20 (1st ed. 1905) (“The Law of Nations and the Municipal Law of the single States are essentially different from each other. . . . Municipal Law regulates relations between the individuals under the sway of the respective State and the relations between this State and the respective individuals. International Law, on the other hand, regulates relations between the member States of the Family of Nations.”); see also HEINRICH TRIEPEL, *VÖLKERRECHT UND LANDESRECHT* 9 (1899).

relationship between the State and private individuals. A broad interpretation of umbrella clauses is viewed as transforming breaches of contract into breaches of a treaty, although the investor is not a subject of international law.<sup>27</sup> The more restrictive approach is, therefore, driven, as the Tribunal in *El Paso v. Argentina* pointed out, by avoiding the “far-reaching consequences of a broad interpretation of the so-called umbrella clause, quite destructive of the distinction between national legal orders and the international legal order”.<sup>28</sup> Under this approach, tribunals treat the contract claim/treaty claim distinction as a firm rule of customary international law that could only be displaced by treaty provisions that express more clearly the intention of States to break with the purportedly strict distinction between international and municipal law. The wording of umbrella clauses, by contrast, is not considered to be sufficient for this objective.<sup>29</sup>

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27. *El Paso Energy*, ICSID Case No. ARB/03/15, para. 82 (“[A]n umbrella clause cannot transform any contract claim into a treaty claim, as this would necessarily imply that any commitments of the State in respect to investments, even the most minor ones, would be transformed into treaty claims.”); see also *id.*, para. 77 (pointing out that a broad interpretation of the umbrella clause would yield the consequence that “the division between the national legal order and the international legal order is completely blurred”); *SGS v. Pakistan*, ICSID Case No. ARB/01/13, at para. 172 (describing umbrella clauses as resulting in a “transubstantiation of contract claims into BIT claims”).

28. *El Paso Energy*, ICSID Case No. ARB/03/15, para. 82; see also *SGS v. Pakistan*, ICSID Case No. ARB/01/13, at para. 166 (“As a matter of textuality . . . the scope of Article 11 of the BIT, while consisting in its entirety of only one sentence, appears susceptible of almost indefinite expansion.”). The emphasis on the delineation between the national and the international legal order echoes some earlier writings on umbrella clauses. In view of the blurring effect the clauses have on the relationship between national and international law, Prosper Weil asserted that his interpretation would have to focus on the delineation of the national and international legal order. See Weil, *supra* note 3, at 101 (“[L]e problème ne soit plus seulement, dans ce cas, de définir les droits et obligations respectives des deux parties, mais également, et peut-être au premier chef, celui des frontières entre les divers ordres juridiques.”).

29. See *SGS v. Pakistan*, ICSID Case No. ARB/01/13, at para. 171 (holding that the clause in question in the Swiss-Pakistani treaty “would have to be considerably more specifically worded before it can reasonably be read in the extraordinarily expansive manner submitted by the Claimant”). Similarly on the relationship between established rules and principles of international law and overriding treaty provisions, see *Elettronica Sicula S.p.A. (ELSI) (United States of America v. Italy)*, 1989 I.C.J. 15, 42 (Judgment of July 20), which states that “the Chamber finds itself unable to accept that an important principle of customary international law should be held to have been tacitly dispensed with, in the absence of any words making clear an intention to do so.” See also *Legal Consequences for States of the Continued Presence of South Africa in Namibia (South West Africa) Notwithstanding Security Council Resolution 276*, 1971 I.C.J. Reports 16, 47 (Advisory Opinion of June 21);



In essence, the broader or "plain meaning" approach can be characterized as a *contract centered* approach that focuses on the contractual bond between investor and State and its implementation, while the more restrictive view is primarily driven by the systematic concern to delineate the scope of application of the domestic and the international legal orders. This approach is, therefore, primarily *contract law centered*<sup>30</sup> and stresses the importance of the applicable legal order for determining the rights and obligations in investor-State relations. The *contract centered* approach perceives the contract primarily as a social and economic bond between the parties that empowers them to order their mutual relations autonomously,<sup>31</sup> while the *contract law centered* approach understands the contract as a legal institution that restricts the private ordering of the parties and embeds their relations into and restricts their autonomy within the confines of a legal framework.<sup>32</sup> For the *contract law centered* approach, contracts only exist within the limits of the law,<sup>33</sup> whereas the *contract*

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The Loewen Group, Inc. and Raymond L. Loewen v. United States of America, ICSID Case No. ARB(AF)/98/3, Award, para. 160 (June 26, 2003); cf. Amoco International Finance Corporation v. Iran, 15 Iran-U. S. Claims Trib. Rep. 189, 222 (1987) (discussing the importance of customary international law for interpreting treaty law).

30. The term "contract law" in this context is understood in a broad and non-technical sense as designating the law that governs the contractual relations between the parties. It is not understood in the more technical terms as the specific field of law that governs contractual relations in general.

31. See Maurice Bourquin, *Arbitration and Economic Development Agreements*, 15 BUS. LAW. 860, 867 *et seq.* (1960) (arguing that special arbitration tribunals between states and private parties "throw[] into relief the special position of the legal relationship resulting from the agreement"); Alfred Verdross, *Protection of Private Property under Quasi-International Agreements*, NEDERLANDS TIJDSCHRIFT VOOR INTERNATIONAAL RECHT, JULY 1959, at 356-59 (1959) (arguing that "an agreement concluded in application of the principle 'pacta sunt servanda' can found a new community"). See generally Alfred Verdross, *Quasi-International Agreements and International Economic Transactions*, 18 Y.B. WORLD AFF. 230 (1964); Weil, *supra* note 3, 177-78.

32. This approach becomes apparent, for example, in F. A. Mann, *State Contracts and State Responsibility*, 54 AM. J. INT'L L. 572, 581 (1960) (stating that the "law [governing a contract] 'not merely sustains but, because it sustains, may also modify or dissolve the contractual bond'" (quoting Kahler v. Midland Bank LD., [1950] A.C. 24, 56 (H.L.) (appeal taken from Eng.) (U.K.)).

33. Cf. Weil *supra* note 3, at 181-88 ("On voit mal comment la volonté des parties pourrait à elle seule engendrer un nouvel order juridique; cette volonté ne produit elle-même des effets de droit que dans la mesure où elle s'intègre dans un ordre préexistant qui décide que l'accord des volontés peut produire, dans certaines conditions, de tels effets de droit. Le principe pacta sunt servanda et celui de l'autonomie de la volonté eux-mêmes ne flottent pas dans le vide, et il faut un

*centered* approach attributes to the governing law the function of backing up the economic exchange the contracting parties envisage and that underlies their relations. It stresses the parties' autonomy and considers that their relations are established by force of their contractual consensus, not by any governing law. The difference between both approaches reflects the difference between understanding contracts primarily as embedded social institutions versus understanding them primarily as a regulated social phenomenon.<sup>34</sup>

As will be argued in this section, the *contract law centered* approach that focuses primarily on the distinction between breaches of contracts and breaches of treaties drawn by the dualist tradition in international law, with its categorical national/international law divide, inhibits investor-State contracting by increasing the costs of foreign investment activities. Umbrella clauses aim at overcoming such impediments that stem from the limited capacity of host States to make credible commitments under the dualist conception by opening investor-State dispute settlement to claims for the breach of promises of the host State vis-à-vis the foreign investor. In terms of methodology, it is suggested that the starting point for the legal analysis and construction of umbrella clauses should be *contract centered* in stressing the economic rationales and incentives that are at play in investor-State cooperation and contracting, rather than taking the *contract law centered* approach that interprets umbrella clauses against the background of the abstract relationship between the international and the domestic legal orders without taking note that this approach can have detrimental effects for investor-State cooperation by making it more cost-intensive.

Accordingly, this section first outlines the institutional infrastructure that is necessary for efficient consensual investor-State cooperation and outlines the importance of effective dispute settlement mechanisms as a backbone for such cooperation. Secondly, it shows that enforcement mechanisms for host State promises are often not provided by domestic legal

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système de droit pour leur conférer force juridique.”).

34. On the underlying differences in understanding contracts as legal and social institutions and the need to combine both views, see Gunther Teubner, *In the Blind Spot: The Hybridization of Contracting*, 8 THEORETICAL INQUIRIES IN LAW 51 (2007); Peer Zumbansen, *The Law of Society, Governance Through Contract*, CLPE Research Paper 2/2007, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=9888610](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=9888610) (to appear in *Indiana Journal of Global Legal Studies*).

orders, in particular those without independent and efficient courts, nor by the traditional system of international law with its national/international law divide and its primary focus in inter-State dispute resolution. Thirdly, this part argues that even today investment treaties without umbrella clauses remain attached to the traditional dualist vision of international law in distinguishing between the State as a sovereign actor and its capacity as a contractor. Consequently, even investment treaties without an umbrella clause are often unable to promote efficient "private ordering" between investors and host States. This section underscores the argument that the dualist approach to interpreting umbrella clauses disregards the importance of the enforcement of promises for cost-efficient investor-State cooperation.

#### A. EFFICIENT COOPERATION, CREDIBLE COMMITMENTS, AND THE ENFORCEMENT OF HOST STATE PROMISES

As with private parties, cooperation in investor-State relations requires assurances that each party can rely on the other party living up to promises made.<sup>35</sup> Various factors play a role in achieving compliance with the original promises. Reputation, community pressure, the moral obligation to keep promises, or self-interest may all contribute to this objective. In some situations, agreements are therefore self-enforcing without the need for any external stabilization, because the benefits from unilaterally defecting from them will not outweigh the benefits derived from compliance. In most cases, however, investor-State cooperation does not fall into the category of self-enforcing agreements. On the contrary, in the typical situation underlying an investor-State contract the host State can benefit by unilaterally defecting from its obligation after the investor has completed parts of its initial performance.<sup>36</sup>

Let us, for example, assume an investor and a host State

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35. See, on this and the following, Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 556–62 (2003); see also Andrew T. Guzman, *Why LDCs Sign Treaties That Hurt Them: Explaining the Popularity of Bilateral Investment Treaties*, 38 VA. J. INT'L L. 639, 658 *et seq.* (1998). For a game-theoretic reconstruction, see ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 185 *et seq.* (3d ed. 2000).

36. The underlying change in the incentive structure after one party has started performing or placed an asset under the control of the other party is also described as a hold-up problem. See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, AND RELATIONAL CONTRACTING* 52 *et seq.* (1987).

have entered into a contract for the construction of a power plant in the host country and its subsequent operation by the investor for thirty years. Under the contract, the investor is required to build the plant within a certain period, to operate it, and to supply electricity. The host State, in turn, grants the investor a thirty-year concession for the operation of the plant and gives guarantees for the investor's tariff calculation. Based on their mutual expectation, the contract aims at realizing gains from cooperation: the investor intends to make profits by selling energy; the host State expects to be supplied with energy and benefit from the investor's know-how in constructing and operating the plant. Yet, the investor's investment decision is based on the expectation to earn future cash returns from the operation of the plant and presupposes that the host State will, *inter alia*, comply with its original promises not to interfere with the tariff regime.

In economic terms, the situation of the foreign investor is characterized by the asset or transaction specificity of the investment. Once its obligations to construct the plant have been fulfilled, the investor cannot simply sell the plant or the energy to third parties or relocate the plant if the host State does not comply with its obligations, for example by unilaterally changing the investment contract, imposing additional obligations on the investor, or even completely withdrawing from its original promises in order to extract a greater benefit from the bargain. Unlike in situations of self-enforcing contracts, where "the threat by either party no longer to deal with the other is sufficient *in and of itself* to induce performance,"<sup>37</sup> investor-State contracts typically involve a risk that the host State will not abide by its original promise, but try to "renegotiate" the original bargain or even openly breach it. The typical situation in investor-State relations is thus prone to be affected by *opportunistic behavior* of the host State with non-recoverable, sunk costs as a consequence. Certainly, the reverse situation of foreign investors behaving opportunistically and attempting to renege on their original promises also exists. However, the host State as a sovereign actor is typically able to react to such conduct by unilaterally imposing sanctions upon the investor and enforcing them against the assets of the investment project.<sup>38</sup> The fact that the host State disposes of the

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37. Schwartz & Scott, *supra* note 35, at 557 (emphasis in the original).

38. There are exceptional situations where this mechanism does not work effectively, for example, because the investor does not have any or sufficient assets

sovereign power to unilaterally impose decisions on the foreign investor structurally disfavors the investor in reacting to opportunistic behavior of the other party in investor-State relations.

As a consequence, the rational and risk-adverse investor will choose not to invest at all or only invest at a higher premium that takes into account the potential risk of the host State renegeing on its original promises. Higher costs for the investor, which affect the price structure of foreign investment projects and make them less cost-efficient, will be the result if investor-State cooperation is impeded by this so-called hold-up problem.<sup>39</sup> While the reputation of the host State and the political pressure exercised by other States, including the investor's home State, might constitute some incentive for host States to comply with promises they made vis-à-vis foreign investors,<sup>40</sup> often the only possibility for the host State to make credible commitments and immunize investor-State cooperation against *ex post* opportunistic behavior by the host State is through the establishment of independent third-party dispute settlement mechanisms, such as courts or arbitral tribunals.<sup>41</sup> Such *ex post* control and governance mechanisms<sup>42</sup> ensure that the initially-struck bargain will be upheld and thus empower the parties to make credible commitments in order to engage in cost-efficient private ordering.

## B. STATE SOVEREIGNTY AND SHORTCOMINGS IN THE ENFORCEMENT OF HOST STATE PROMISES

Traditionally, however, the concept of State sovereignty has militated against the establishment of dispute settlement and enforcement mechanisms that allowed for efficient private ordering in investor-State relations. Sovereignty was developed

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within the host State's jurisdiction. Such exceptional cases will, however, be disregarded for the further legal analysis. They pose entirely different problems from situations typically faced by foreign investors.

39. See *supra* note 36. Cf. Schwartz & Scott, *supra* note 35, at 561 (“[W]hen contracts are unenforceable a sophisticated seller will refuse to produce the specialized product, even though producing it would maximize expected surplus.”).

40. Anne van Aaken, *Perils of Success? The Case of International Investment Protection*, 9 EUR. BUS. ORG. L. REV. 1, 14 (2008).

41. Cf. Zachary Elkins et al., *Competing For Capital: The Diffusion of Bilateral Investment Treaties, 1960-2000*, 60 INT'L ORG. 811, 823-24 (2006).

42. See Alec Stone Sweet, *Judicialization and the Construction of Governance*, 32 COMP. POL. STUD. 147 (1999) (outlining an understanding of third-party dispute settlement as a mechanism of governance).

to shield the State against interferences by other States and to justify internally the State's power to impose binding decisions and, if necessary, enforce them. When understood broadly as the State's ultimate power, sovereignty clashes with the necessity for the host State to make credible and enforceable commitments so as to enter into binding agreements vis-à-vis foreign investors. It constitutes an impediment to efficient investor-State cooperation, instead of empowering States in their relationship with foreign investors. As will be argued in this section, effective third-party dispute settlement and enforcement mechanisms for host State promises are often lacking, both on the domestic level and under the traditional customary international law framework. As will be shown, the latter is particularly incapable of stabilizing investor-State contracts both substantively and procedurally. Finally, this section argues that these shortcomings can only be alleviated imperfectly in the absence of efficient enforcement mechanisms based on contractual arrangements between investors and host States.

### *1. Enforcement of Host State Promises in Domestic Courts*

The courts of the host State will often not be well positioned to enforce the State's promises as they relate to foreign investors. Existing or perceived bias against foreign investors, or even the lack of an independent and efficient judiciary, may diminish the ability of the courts of the host State to serve as efficient and effective institutions to enforce host State promises and counter opportunistic host State behavior. Judicial independence is particularly compromised by close institutional ties between courts and the executive, and missing safeguards against political influence on court proceedings. Furthermore, particularly in many developing countries, the low income of judges and the insufficient financial support of courts often not only aid and abet corruption,<sup>43</sup> but also result in lengthy and ineffective dispute resolution. Such factors may compromise the ability of the host State's domestic courts to function as independent and efficient dispute resolvers that effectively back

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43. On corruption in the judiciary, see Eduardo Buscaglia & Maria Dakolias, *An Analysis of the Causes of Corruption in the Judiciary*, 30 LAW & POL'Y INT'L BUS. 95 (1999); Maria Dakolias & Kimberley Thachuk, *The Problem of Eradicating Corruption from the Judiciary: Attacking Corruption in the Judiciary: A Critical Process in Judicial Reform*, 18 WIS. INT'L L.J. 353 (2000).

up credible commitments of the host State vis-à-vis a foreign investor.<sup>44</sup>

The possibility of bringing a claim in the investor's home jurisdiction or in other third-country courts is often equally limited. Here, the concept of sovereign equality compromises effective dispute resolution because the judiciary outside the host State is often reluctant to subject foreign sovereigns to full-fledged judicial scrutiny and control. Various instruments, in particular state immunity and doctrines of judicial restraint, such as the act of state doctrine, constitute significant limits to subjecting foreign States to third-country jurisdiction.<sup>45</sup> Furthermore, third-country courts often exercise judicial restraint in view of the foreign relations interests of their own government and are thus reluctant to subject foreign sovereigns to full-fledged judicial scrutiny. Courts outside the host State are, therefore, equally incapable of providing effective enforcement mechanisms that could back up the credibility of promises a host State makes vis-à-vis foreign investors.

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44. Exceptions to these observations exist, in particular in countries with a well-developed judicial system that provides for effective and independent protection against government conduct. This may also account for the non-inclusion of an investor-State dispute settlement mechanism in the recent United States-Australia Free Trade Agreement. See William S. Dodge, *Investor State Dispute Settlement Between Developed Countries: Reflections on the Australia-United States Free Trade Agreement*, 39 VAND. J. TRANSNAT'L L. 1 (2006).

45. See M. SORNARAJAH, *THE PURSUIT OF NATIONALIZED PROPERTY*, 253-301 (1986). Specifically on the situation in the United States, see Ronald Mok, *Comment: Expropriation Claims in United States Courts: The Act of State Doctrine, the Sovereign Immunity Doctrine, and the Foreign Sovereign Immunities Act. A Roadmap for the Expropriated Victim*, 8 PACE INT'L L. REV. 199 (1996). Under the U.S. act of state doctrine for example, "the Judicial Branch will not examine the validity of a taking of property within its own territory by a foreign sovereign government . . . in the absence of a treaty or other unambiguous agreement regarding controlling legal principles, even if the complaint alleges that the taking violates customary international law." *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398, 421 (1964). The political question doctrine results in the self-restraint of courts in the United States regarding foreign policy issues that. See *Baker v. Carr*, 369 U.S. 186, 212 n.31 (1962) ("The conduct of the foreign relations of our Government is committed by the Constitutions to the Executive and Legislative—the 'political'—Departments of the Government, and the propriety of what may be done in the exercise of this political power is not subject to judicial inquiry or decision.") (citing *Oetjen v. Central Leather Co.*, 246 U.S. 297, 302 (1918)). Comparable doctrines also exist under other domestic legal systems.

## 2. Limited Protection of Investor-State Contracts under Customary International Law

The concept of State sovereignty also limits the power of customary international law to stabilize investor-State contracts *ex post*. What is primarily lacking in this context is a procedural remedy for investors to hold host States accountable in an international forum. Instead, under the dualist conception of international law the relationship between foreign investors and host States is mediated through an inter-State prism that requires investors to seek diplomatic protection on the international level through its home State. This structure is generally insufficient because the inter-State settlement of investment disputes between the investor's home State and the host State does not represent an adequate replacement for dispute resolution directly between the foreign investor and the host State. Apart from this procedural aspect, customary international law is also limited as regards the substantive protection of investor-State contracts and similar forms of investor-State cooperation.

### a. Insufficiencies of Diplomatic Protection as an Enforcement Mechanism

International law in its positivist reading as *ius inter gentes* posited that “[s]tates solely and exclusively are the subjects of International Law. This means that the Law of Nations is a law for the international conduct of States, and not of their citizens.”<sup>46</sup> Obligations under international law could therefore not exist directly in relation to a foreign investor. Instead, the investor was originally considered to be subject only to the municipal law of the host State.<sup>47</sup> Accordingly, a breach of the host State's promises was first and foremost a matter of municipal law and did not find its direct corollary in international law. The paradigmatic idea underlying customary international law was rather that the violation of certain interests of foreign nationals through certain government actions, such as expropriatory or arbitrary conduct,<sup>48</sup> constituted a violation against the alien's home State.

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46. OPPENHEIM'S INTERNATIONAL LAW, *supra* note 3, § 13, at 18–19.

47. Attempts at the internationalization of investor-State relations only came about at a later stage. See Weil, *supra* note 3, at 157–88.

48. See *infra* Part II.B.2.b (discussing the types of State conduct that international law targeted).



This understanding found its classical expression in the *Mavrommatis Palestine Concessions Case* where the Permanent Court of International Justice (PCIJ) contrasted the investor-State relation with the inter-State relation and distinguished categorically between the municipal and the international legal order as governing the different relations: “[b]y taking up the case of one of its subjects and by resorting to diplomatic action or international judicial proceedings on his behalf, a State is in reality asserting its own rights—its right to ensure, in the person of its subjects, respect for the rules of international law.”<sup>49</sup>

Independent from the fact that the host State initially could not assume obligations under international law vis-à-vis the foreign investor in order to make credible commitments, the system of diplomatic protection itself suffers from structural shortcomings that disable it from efficiently stabilizing investor-State relations *ex post*. First, diplomatic protection is a right of a State to “ensure in the person of its nationals respect for the rules of international law.”<sup>50</sup> There is, however, no corresponding duty of the home State toward its own nationals to grant diplomatic protection. Instead, States remain free to exercise this right in a discretionary way.<sup>51</sup> Furthermore,

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49. *Mavrommatis Palestine Concessions (Greece v. Gr. Brit.)*, 1924 P.C.I.J. (ser. A) No. 2, at 12 (Aug. 30); *see also Barcelona Traction, Light and Power Co. (Belg. v. Spain)*, 1970 I.C.J. 3, 46–47 (Feb. 5); *Nottebohm (Liech. v. Guat.)*, 1955 I.C.J. 4, 24 (April 6); *Panevezys-Saldutiskis Railway (Est. v. Lith.)*, 1939 P.C.I.J. (ser. A/B) No. 76, at 16; *Payment of Various Serbian Loans Issued in France (Fr. v. Kingdom of the Serbs, Croats and Slovenes)*, 1929 P.C.I.J. (ser. A) No. 20, at 17 (July 12); *Factory at Chorzów (F.R.G. v. Pol.)*, 1928 P.C.I.J. (Ser. A) No. 17, at 28 (Sept. 13) (“Rights or interests of an individual the violation of which rights causes damage are always in a different plane to rights belonging to a State . . . . The damage suffered by an individual is never therefore identical in kind with that which will be suffered by a State; it can only afford a convenient scale for the calculation of the reparation due to the State.”).

50. *See cases cited supra* note 49.

51. *See Barcelona Traction, Light And Power Co.*, 1970 I.C.J. at 44 (“The State must be viewed as the sole judge to decide whether its protection will be granted, to what extent it is granted, and when it will cease. It retains in this respect a discretionary power the exercise of which may be determined by considerations of a political or other nature, unrelated to the particular case.”); EDWIN M. BORCHARD, *THE DIPLOMATIC PROTECTION OF CITIZENS ABROAD OR THE LAW OF INTERNATIONAL CLAIMS*, 29–30, 354, 356, 363–65 (Banks Law Publ'g Co. 1915). Likewise, most domestic legal systems do not oblige the State to pursue claims of their nationals by means of diplomatic protection. *See Kaunda v. President of the Republic of S. Afr.*, 44 Int'l L. Materials 173 (2005) (on the situation in South Africa); *Abbasi v. Secretary of State for the Home Department*, (2002) E.W.C.A. Civ. 1598 (Eng. and Wales), 126 Int'l L. Rep. 685 (on English law); *Entscheidungen des*

diplomatic protection and inter-State dispute settlement are subject to the requirement to exhaust local remedies.<sup>52</sup> While this affords the host State an opportunity to redress the violation of rights of a foreign investor in its own courts, the rule constitutes an impediment to efficient *ex post* stabilization of investor-State contracts to the extent the host State's courts are not impartial and independent enough in sanctioning opportunistic behavior.<sup>53</sup>

Secondly, as a consequence of the distinction between domestic and international law, the home State is vested, under international law, with exclusive control over the rights of their nationals on the international level and is entitled to settle, waive, or modify the rights of their nationals by an international agreement with the host State.<sup>54</sup> In practice, this entitlement has led to the settlement by lump-sum agreements of international claims concerning the violation of the rights of foreigners.<sup>55</sup> These agreements were used in particular to deal with the compensatory framework in the aftermath of armed conflicts or other large-scale events like revolutions and traditionally fixed the compensation of foreign nationals to a fraction of the full claim and ruled out any exceeding compensation.

Thirdly, in view of the distinction between the rights of the investor and the rights of its home State the entitlement to receive compensation for the violation of international law protecting foreign nationals is not vested in the alien but in its

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Bundesverfassungsgericht [BVerfGE] [F.R.G. Federal Constitutional Court] 55, 349 (1980), 90 Int'l Law Rep. 387 (on the situation in Germany); see also Annemarieke Vermeer-Künzli, *Restricting Discretion: Judicial Review of Diplomatic Protection*, 75 NORDIC J. INT'L L. 279 (2006) (discussing national jurisprudence and developments on the international level and observing an emerging development towards a State's obligation to exercise diplomatic protection in cases of serious violation of human rights law).

52. See CHITTHARANJAN FELIX AMERASINGHE, *LOCAL REMEDIES IN INTERNATIONAL LAW* (2nd ed. 2005); A. A. CANCADO TRINDADE, *THE APPLICATION OF THE RULE OF EXHAUSTION OF LOCAL REMEDIES IN INTERNATIONAL LAW* (1983).

53. Cf. *supra* Part II.B.1.

54. BORCHARD, *supra* note 51, at 366–75; see also RUDOLF DOLZER, *EIGENTUM, ENTZEIGNUNG UND ENTSCHÄDIGUNG IM GELTENDEN VÖLKERRECHT* 136–39, 147 (1985) (arguing that human rights law restricts the home State's disposition over claims of its nationals); JULIANE HAGELBERG, *DIE VÖLKERRECHTLICHE VERFÜGUNGSBEFUGNIS DES STAATES ÜBER RECHTSANSPRÜCHE VON PRIVATPERSONEN* 49–52 (2006).

55. See RICHARD B. LILLICH & BURNS H. WESTON, *INTERNATIONAL CLAIMS: THEIR SETTLEMENT BY LUMP-SUM AGREEMENTS* (1975); BURNS H. WESTON ET AL., *INTERNATIONAL CLAIMS: THEIR SETTLEMENT BY LUMP-SUM AGREEMENTS* 1975–95 (1999).

home State. Compensation therefore did not have to be paid to the investor, but to the home State that espoused the claim.<sup>56</sup> The home State, in turn, is under no obligation to pass the compensation on to the investor who suffered the damage.<sup>57</sup> Taken together, these factors illustrate the insufficiencies of diplomatic protection as a procedural means of enforcing host State promises vis-à-vis foreign investors and enabling host States to make credible commitments. The insufficiencies of diplomatic protection ultimately also explain the creation of investor-State arbitration as a direct recourse to enforce investor's rights against host States.

#### b. Insufficiencies in Substantive Stabilization of Host State Promises

The capacity of host States to make credible foreign investor commitments in investor-State contracts is not just limited procedurally under customary international law. Even if an investor managed to convince its home State to grant diplomatic protection, customary international law only granted relief to a limited scope of breaches of investor-State contracts and similar instruments.<sup>58</sup> Due to the categorical divide between international law and municipal law, the host State's violation of an obligation under an investor-State contract did not directly correspond to a violation of an obligation under international law, as the investor was not a subject of international law and the investor's home State not a party to the contract. This categorical distinction between the breach of the investor-State contract and the breach of international law was difficult to bridge under the traditional dualist conception. Furthermore, the host State, as the sovereign over the contract's governing law, was generally considered to be entitled to change it.<sup>59</sup>

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56. BORCHARD, *supra* note 51, at 356–59, 383–88; HAGELBERG, *supra* note 52, at 51.

57. See HAGELBERG, *supra* note 54, at 51 n.110, for further references.

58. See, e.g., Robert Y. Jennings, *State Contracts in International Law*, 37 BRIT. Y.B. INT'L L. 156 (1961) (qualifying the debate as characterized by a “difference of opinion about basic principles which has hitherto rendered abortive the most strenuous efforts to systematize this part of the law”); Jean-Flavien Lalive, *Contrats entre états ou entreprises étatiques et personnes privées*, 181 RECUEIL DES COURS [RdC] 9 (1983); Charles Leben, *La théorie du contrat d'Etat et l'évolution du droit international des investissements*, 302 RDC 197 (2004); Mann, *supra* note 32, at 574–77; Weil, *supra* note 3.

59. Mann, *supra* note 32, at 581 (“Contracts are governed by the law determined by the private international law of the forum. That law ‘not merely

Accordingly, “[i]f under the latter system of law [i.e. municipal law] no breach of contract occurs, it is not open to public international law to assert the contrary.”<sup>60</sup>

Despite the categorical divide between municipal and international law, contract claims and treaty claims, customary international law settled on an intermediary position that afforded some limited protection to investor-State contracts. Due to the lack of reciprocity of international law obligations between the host State and the foreign investor, the solution under customary international law was that a breach of an investor-State contract, while in itself unable to constitute a breach of international law, could constitute a violation of an inter-State obligation so long as the breach of contract also constituted a tort with respect to the investor’s home State.<sup>61</sup> Such torts could exist in cases in which a host State expropriated an investor-State contract,<sup>62</sup> interfered with the contract in an arbitrary manner,<sup>63</sup> or committed an independent breach of international law through a denial of justice,<sup>64</sup> always provided that the conduct of the State was noncommercial in character.<sup>65</sup>

A simple commercial breach of an investor-State contract by the host State was, by contrast, considered as insufficient in order to result in a violation of international law, since such a breach exclusively concerned the contractual bond, without touching on the international relations between States.<sup>66</sup> In sum, the position under customary international law was the

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sustains but, because it sustains, may also modify or dissolve the contractual bond.’ . . . If, therefore, the debtor relies on changes in the proper law, he does what he is entitled to do and cannot be charged with a breach of contract, his undertaking being limited to perform in accordance with the terms of the contract as sanctioned by the provisions of the proper law.”)

60. *Id.* at 582.

61. See Weil, *supra* note 3, at 137 (“la responsabilité de l’Etat naît en matière contractuelle d’éléments extérieurs au contrat, constitutifs en eux-mêmes d’un délit international”).

62. See Jennings, *supra* note 58, at 173–79 (referencing the relevant case law).

63. *Id.* at 165.

64. See generally JAN PAULSSON, DENIAL OF JUSTICE IN INTERNATIONAL LAW (2005).

65. See Stephan M. Schwebel, *On Whether the Breach by a State of a Contract with an Alien Is a Breach of International Law*, in INTERNATIONAL LAW AT THE TIME OF ITS CODIFICATION: ESSAYS IN HONOUR OF ROBERTO AGO, 401, 410–11 (1987) (providing case law of international tribunals endorsing this view).

66. Weil, *supra* note 3, at 138 (“inexécution [du contrat] ne constitue jamais *per se* un acte contraire au droit international, et il faut toujours quelque chose de plus et d’autre pour qu’il y ait un acte internationalement illicite”).

following:

[W]hile mere breach by a State of a contract with an alien (whose proper law is not international law) is not a violation of international law, a "non-commercial" act of a State contrary to such a contract may be. That is to say, the breach of such a contract by a State in ordinary commercial intercourse is not, in the predominant view, a violation of international law, but the use of the sovereign authority of a State, contrary to the expectations of the parties, to abrogate or violate a contract with an alien, is a violation of international law.<sup>67</sup>

This limited scope of protection of investor-State contracts under customary international law leaves important gaps in stabilizing investor-State relations *ex post* against breaches of contract and thus limits the scope of the host State's capacity to make credible commitments and participate in efficient investor-State cooperation. Apart from disputes regarding changes in the governing law caused by the host State's sovereign conduct, disputes about the proper scope of a contractual obligation as well as disputes involving the simple nonperformance of contractual obligations outside the State's sovereign conduct were disregarded by the scope of international law. Customary international law therefore not only left islands of non-protection against the change of law by the host State; it also failed to protect against (alleged) breaches based on the opportunistic behavior arising out of the host State's commercial conduct.

### *3. Insufficiencies of Alternative Investment Protection under Investor-State Agreements*

Certainly, large-scale investment contracts have always contained contractual arbitration clauses as well as choice of law clauses subjecting a contract to a foreign law as governing the contractual relations,<sup>68</sup> stabilization clauses that isolate an investor-State contract from future changes of the law governing a contract,<sup>69</sup> or internationalization clauses that

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67. Schwebel, *supra* note 65, at 408-09.

68. The choice of a foreign law is often used in contracts involving foreign debt where States regularly subject bonds to one of the laws in force at the locations of the principle financial centers, such as New York, London, Frankfurt, or Paris.

69. Specifically on stabilization clauses, see HANNO MERKT, INVESTITIONSSCHUTZ DURCH STABILISIERUNGSKLAUSELN (1990); F. V. Garcia-Amador, *State Responsibility in Case of "Stabilization" Clauses*, 2 TRANSNAT'L. L. & POL'Y 23 (1993). On choice of law and internationalization clauses in investor-State contracts see KARL-HEINZ BÖCKSTIEGEL, DER STAAT ALS VERTRAGSPARTNER

subject a contract to international law as the governing law. By means of such contractual arrangements, investors and States were able to deal with some of the problems arising out of the national/international law divide under customary international law and the difficulties of host States to make credible and enforceable commitments vis-à-vis foreign investors absent effective third-party dispute settlement and enforcement mechanisms. Arbitration clauses removed the settlement of disputes from the realm of domestic adjudication and alleviated the deficiencies existing in this respect;<sup>70</sup> choice of law clauses, stabilization clauses, and internationalization clauses, in turn, constitute a contractual solution to protect investor-State contracts against unilateral changes in the governing law by the host State that might affect the contractual equilibrium.<sup>71</sup>

Nevertheless, purely contractual arrangements have significant drawbacks compared to a permanent institutional structure that provides for dispute settlement and enforcement of host State promises vis-à-vis foreign investors in general as it is done under modern investment treaties.<sup>72</sup> Above all, in the absence of permanent dispute settlement and enforcement mechanisms, investor-State cooperation constantly requires negotiation about such mechanisms—negotiations that are not only time-consuming, but make the enforceability of the host State's promise itself part of the bargaining mass—making not only the negotiations but the entire investment cooperation less efficient.

Furthermore, while large-scale multinational firms may prove quite successful in such negotiations, even to a point where it makes no difference whether investment protection is offered by an international treaty or by the contractual framework set out in an investor-State contract, the situation for middle or even small-scale foreign investors is different. They may not have the necessary market and bargaining power to negotiate comparable protection mechanisms. Smaller investors are thus placed at a structural disadvantage compared to larger investors because the host State commitments in relation to them may be less credible due to the absence of pre-

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AUSLÄNDISCHER PRIVATUNTERNEHMEN 76–144 (Athenaum Verlag 1971).

70. See *supra* Part I.B.1.a.

71. See *supra* Part I.B.2.b.

72. See Barton Legum, *The Innovation of Investor-State Arbitration under NAFTA*, 43 HARV. INT'L L.J. 531 (2002) (discussing the differences between State consent in modern investment treaties and more classical cases).

existing institutional backups for private ordering between foreign investors and States. Consequently, smaller investors are less likely to make foreign investments because the risk associated with the lack of enforceable commitments on behalf of the host State is too high.<sup>73</sup> In any case, the lack of a non-contractual structure to stabilize investor-State cooperation *ex post* and ensure the enforceability of host State promises will make the investments more expensive, not only for the investor, but also for the host State and its constituency. The investments are more expensive because the investor's goods and services will be offered at a higher price. From a macroeconomic perspective, contractual arrangements between investors and host States will not be able to make up for the limited capacity of States to make credible and enforceable commitments in investor-State relations.

#### C. THE LIMITED PROTECTION OF INVESTOR-STATE CONTRACTS UNDER INVESTMENT TREATIES

As long as host States did not consider foreign investment an important factor for their economy, the inability (or unwillingness) of States to make credible commitments *vis-à-vis* foreign investors was of little concern. Once attracting foreign investment became desirable, however, the monolithic conception of State sovereignty developed into a drawback, since it vitiated the capacity of host States to make credible contractual commitments with respect to foreign investors, both procedurally as well as regarding the substantive stability of the law governing investor-State relations. Consequently, an incongruity emerged between the need for and the desirability of foreign investment and the legal protection of foreign investment under traditional international law. It is against this background that the institutionalization of investor-State dispute settlement has to be viewed.<sup>74</sup> By allowing foreign investors to have direct recourse to dispute settlement against the host State and enforce the State's promises, host States are able to make credible commitments *vis-à-vis* foreign investors,<sup>75</sup> thereby reducing the costs of foreign investments and rendering

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73. See *supra* Part II.A.

74. Cf. Sweet, *supra* note 42, at 160 (“[W]hen existing rules cannot sustain social exchange at an optimal level, people have an interest in developing new ones.”).

75. Cf. Elkins et al., *supra* note 41, at 823–24.

investor-State cooperation more efficient.

However, even under modern investment treaties the scope of the host State's incapacity to make credible commitments under investor-State contracts persists. Although these treaties provide for a number of specific investors' rights, such as fair and equitable treatment and the protection against expropriation, and contain the host State's general and advance consent to arbitration, the protection of contractual promises is still limited in the absence of an umbrella clause. In particular, fair and equitable treatment and the concept of expropriation, both direct and indirect, are interpreted in arbitral practice as being limited to breaches of a sovereign nature, thus excluding commercial State conduct. The traditional contract claim/treaty claim distinction therefore persists in investment treaty arbitration and limits the host State's capacity to fully make credible commitments under treaties that do not contain an umbrella clause. The contract claim/treaty claim distinction plays out on two levels: the jurisdiction of treaty-based tribunals for breaches of investor-State contracts and their substantive protection.

With respect to jurisdiction, arbitral tribunals consistently differentiate between contract and treaty claims. The tribunals support the holding that contract claims are, in principle, excluded from the jurisdiction of treaty-based tribunals.<sup>76</sup> The Annulment Committee in *Aguas del Aconquija v. Argentina*, for example, explained:

A state may breach a treaty without breaching a contract, and *vice versa* . . . . In accordance with this general principle (which is undoubtedly declaratory of general international law), whether there has been a breach of the BIT and whether there has been a breach of contract are different questions. Each of these claims will be determined by reference to its own proper or applicable law—in the case of the BIT, by international law; in the case of the Concession Contract, by the proper law of the contract.<sup>77</sup>

Arbitral tribunals have applied this distinction consistently. The result is the “well established” jurisprudence<sup>78</sup> that a

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76. Exceptions to this principle exist, independently of the existence of an umbrella clause, if the treaty includes a broadly worded arbitration clause covering “any disputes relating to investments.” See *infra* Part III.B.2.

77. *Compañía de Aguas del Aconquija, S.A. and Vivendi Universal v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/97/3, Decision on Annulment, paras. 95–96 (July 3, 2002).

78. *Bayindir Insaat Turizm Ticaret Ve Sanayi A.S. v. Islamic Republic of Pakistan*, ICSID (W. Bank) Case No. ARB/03/29, Decision on Jurisdiction, para. 148



simple, commercial breach of an investor-State contract *per se* does not involve the breach of an investment treaty provision and is thus excluded from the jurisdiction of treaty-based tribunals.<sup>79</sup> With respect to jurisdiction for contract claims, investment tribunals have, therefore, adopted a State-friendly application of the State's consent to arbitration, and grounded this view on traditional notions of the municipal/international law divide. From the perspective of effective *ex post* stabilization of investor-State contracts this jurisprudence did, however, leave gaps of protection, notably with regard to non-sovereign breaches of host State promises vis-à-vis investors.

Similar to the jurisdictional implications of the contract claim/treaty claim distinction, the difference between sovereign interference and commercial conduct also affects the substantive protection accorded to investor-State contracts under

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(Nov. 14, 2005).

79. *See id.*; *Aguas del Tunari S.A. v. Republic of Bolivia*, ICSID (W. Bank) Case No. ARB/02/3, Decision on Objections to Jurisdiction, para. 114 (Oct. 21, 2005); *Camuzzi Int'l S.A. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/03/7, Decision on Jurisdiction, paras. 61 *et seq.* (June 10, 2005); *AES Corporation v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/02/17, Decision on Jurisdiction, para. 94 (May 26, 2005); *CMS Gas Transmission Co. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/01/8, Award, para. 299 (May 12, 2005); *Sempra Energy International v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/02/16, Decision on Objections to Jurisdiction, para. 95 (May 11, 2005); *Impregilo S.p.A. v. Islamic Republic of Pakistan*, ICSID (W. Bank) Case No. ARB/02/17, Decision on Jurisdiction, para. 219 (Apr. 22, 2005); *Siemens A.G. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/02/8, Decision on Jurisdiction, para. 174 (Aug. 3, 2004); *Enron Corporation and Ponderosa Assets L.P. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/01/13, Decision on Jurisdiction – Ancillary Claim, paras. 49 and 51 (Aug. 2, 2004); *PSEG Global Inc., North American Coal Corp., and Konya Ilgin Elektrik Üretim ve Ticaret Limited Sirketi v. Republic of Turkey*, ICSID (W. Bank) Case No. ARB/02/5, Decision on Jurisdiction, para. 158 (June 4, 2004); *Enron Corporation and Ponderosa Assets L.P. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/01/13, Decision on Jurisdiction, para. 91 (Jan. 14, 2004); *Azurix Corp. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/01/12, Decision on Jurisdiction, para. 81 (Dec. 8, 2003); *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, ICSID (W. Bank) Case No. ARB/01/13, Decision on Objections to Jurisdiction, para. 147 (Aug. 6, 2003); *CMS Gas Transmission Co. v. Republic of Argentina*, ICSID (W. Bank) Case No. ARB/01/8, Decision on Objections to Jurisdiction, paras. 72, 76, 80 (July 17, 2003). *Cf. Joy Mining Machinery Limited v. Egypt*, ICSID (W. Bank) Case No. ARB/03/11, Decision on Jurisdiction, paras. 71–82 (July 30, 2004); *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, ICSID (W. Bank) Case No. ARB/02/6, Decision on Objections to Jurisdiction, para. 154 (Jan. 29, 2004); *Alex Genin Eastern Credit Limited, Inc. and A.S. Baltoil v. Republic of Estonia*, ICSID (W. Bank) Case No. ARB/99/2, Award, para. 319 (June 25, 2001); *Eureka*, Partial Award, *supra* note 6, para. 112. *See generally* Guido Santiago Tawil, *The Distinction Between Contract Claims and Treaty Claims: An Overview*, in 14 ICCA CONGRESS SERIES 492 (2006).

investment treaties. Even though a “treaty cause of action is not the same as a contractual cause of action”,<sup>80</sup> investment tribunals have accepted that certain interferences of the host State with investor-State contracts can give rise to treaty claims for violation of the concept of indirect expropriation or the fair and equitable treatment standard.<sup>81</sup>

However, tribunals interpret these investors’ rights as only protecting against sovereign, not commercial breaches. The Tribunal in *CMS v. Argentina*, for example, supported that

[t]he standard of protection of the treaty will be engaged only when there is a specific breach of treaty rights and obligations or a violation of contract rights protected under the treaty. Purely commercial aspects of a contract might not be protected by the treaty in some situations, but the protection is likely to be available when there is significant interference by governments or public agencies with the rights of the investor.<sup>82</sup>

Likewise, the Tribunal in *Impregilo v. Pakistan*, a case involving the breach of an investment contract, emphasized that “only measures taken by Pakistan in the exercise of its sovereign power (‘puissance publique’), and not decisions taken in the implementation or performance of the Contracts, may be considered as measures having an effect equivalent to expropriation.”<sup>83</sup> Similarly, the Tribunal in *Consortium RFCC v. Morocco* stressed that a violation of fair and equitable treatment required conduct by the host State in exercise of sovereign power.<sup>84</sup> Indirect expropriation and fair and equitable

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80. *Aguas del Aconquija*, ICSID Case No. ARB/97/3, at para. 113.

81. See, e.g., *SGS v. Philippines*, ICSID Case No. ARB/02/6, at para. 162; *Mondev International Ltd. v. United States of America*, ICSID (W. Bank) Case No. ARB(AF)/99/2, Award, paras. 98 and 134 (Oct. 11, 2002) (both tribunals asserting that a breach of contract may result in a breach of treaty without, however, establishing criteria for the distinction).

82. *CMS Gas Transmission*, ICSID Case No. ARB/01/8, Award, at para. 299.

83. *Impregilo*, ICSID Case No. ARB/02/17 at para. 281; *accord Consortium RFCC v. Morocco*, ICSID (W. Bank) Case No. ARB/00/6, Award, paras. 63–69 (Dec. 22, 2003) (stating with respect to indirect expropriation that “[p]our qu’il y ait droit à compensation il faut que la personne de l’exproprié prouve qu’il a été l’objet de mesures prises par l’Etat agissant non comme cocontractant mais comme autorité publique”).

84. *Consortium RFCC*, ICSID Case No. ARB/00/6, at para. 51 (“L’Etat, ou son emanation, peuvent s’être comportés comme des cocontractants ordinaires ayant une divergence d’approche, en fait ou en droit, avec l’investisseur. Pour que la violation alléguée du contrat constitue un traitement injuste ou inequitable au sens de l’Accord bilatéral, il faut qu’elle résulte d’un comportement exorbitant de celui qu’un contractant ordinaire pourrait adopter.”); *accord Bayindir*, ICSID Case No. ARB/03/29, at para. 180 *et seq.*; *Salini Costruttori S.p.A & Italstrade S.p.A. v. Hashemite Kingdom of Jordan*, ICSID (W. Bank) Case No. ARB/02/13, Decision on

treatment, therefore, only protect investor-State contracts and similar instruments against interferences based on sovereign conduct of the host State. Purely commercial breaches, by contrast, are in principle not covered under the substantive provisions of an investment treaty.

Sovereign conduct is also necessary in order to find direct expropriation. The Tribunal in *SGS v. Philippines*, for instance, held that “a mere refusal to pay a debt is not an expropriation of property.”<sup>85</sup> Similarly, the Tribunal in *Waste Management v. Mexico* noted that the foreign investor could not bring an expropriation claim for the simple nonpayment of money owed to him by a Mexican municipality under a concession agreement. The Tribunal noted:

In such cases, simply to assert that ‘property rights are created under and by virtue of a contract’ is not sufficient. The mere non-performance of a contractual obligation is not to be equated with a taking of property, nor (unless accompanied by other elements) is it tantamount to expropriation. Any private party can fail to perform its contracts, whereas nationalization and expropriation are inherently governmental acts, as is envisaged by the use of the term ‘measure’ in Article 1110(1).<sup>86</sup>

None of the cases that required sovereign conduct as essential for the breach of an investment treaty involved a treaty with an umbrella clause. Instead, the Tribunal in *Waste Management v. Mexico* even emphasized the lack of an umbrella clause in NAFTA in order to support its conclusion with an *e contrario* argument. Noting that NAFTA Chapter 11, “unlike many bilateral and regional investment treaties . . . does [not] contain an ‘umbrella clause’ committing the host state to comply with its contractual commitments,”<sup>87</sup> the Tribunal implied that the existence of an umbrella clause would have changed the legal assessment of the case and covered the simple non-performance of a contractual obligation.

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Jurisdiction, para. 154 (Nov. 29, 2004).

85. *SGS v. Philippines*, ICSID Case No. ARB/02/6, at para. 161.

86. *Waste Mgmt., Inc. v. Mexico*, ICSID (W. Bank) Case No. ARB(AF)/00/3, Award, para. 174 (Apr. 30, 2004); see also *Parkerings-Compagniet AS v. Republic of Lithuania*, ICSID (W. Bank) Case No. ARB/05/8, Award, para. 443 (Sept. 11, 2007); *Azurix Corp. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/01/12, Award, para. 315 (July 14, 2006); *Generation Ukraine, Inc. v. Ukraine*, ICSID (W. Bank) Case No. ARB/00/9, Award, para. 20–30 (Sept. 16, 2003); *Impregilo*, ICSID Case No. ARB/02/17, at para. 278. Cf. *EnCana Corporation v. Republic of Ecuador* (Canada v. Ecuador), LCIA Case No. UN3481, UNCITRAL, Award of Feb. 3, 2006, paras. 193–94 (concerning direct expropriation requiring a final exercise of sovereign power).

87. *Waste Mgmt.*, ICSID Case No. ARB(AF)/00/3, at para. 73.

In sum, arbitral jurisprudence draws the distinction between contract claims and treaty claims with respect to the concepts of fair and equitable treatment and indirect expropriation based on whether the conduct of the host State is of a governmental or sovereign nature, or whether it was of a purely commercial character and could have equally been performed by a private party. Therefore, in cases of simple breaches of investor-State contracts that do not amount in themselves to a breach of indirect expropriation or fair and equitable treatment, international investment treaties without umbrella clauses and the dualist conception of international law still limit the capacity of States to fully make credible commitments concerning their future ability and willingness to live up to their contractual obligations vis-à-vis foreign investors.

### III. UMBRELLA CLAUSES AS AN ENFORCEMENT MECHANISM FOR HOST STATE PROMISES

Investment treaties without umbrella clauses still leave sufficiently wide gaps for opportunistic breaches of investor-State contracts that cannot be efficiently enforced in international or domestic fora. As a consequence, it is submitted that the inclusion of umbrella clauses in investment treaties constitutes a reaction to the insufficiencies in protection of investor-State contracts against non-sovereign breaches under customary international law and investment treaty concepts such as indirect expropriation and fair and equitable treatment. Umbrella clauses, it is argued, intend to remedy this blind spot by providing a mechanism to make host State promises enforceable and immune against *ex post* opportunistic behavior in general, comprising not only cases of unilateral change of the governing law of the investor-State contract by the host State, but also regarding circumstances that are often viewed as simple contractual disputes. Opportunistic behavior may occur in the form of simple non-performance of contractual obligations by the host State contrary to the governing law. Opportunistic behavior may further occur when the host State takes advantage in bad faith of ambiguities or gaps in the contract. Finally, the regulation of contracts or contract law may have consequences that constitute an opportunistic escape from the

host State's original promise.<sup>88</sup>

The capacity to make credible commitments can be limited not only by a lack of enforcement regarding interferences with investor-State contracts based on the prerogatives of the host State as a sovereign; it can also be affected by enforcement limitations in regard to purely commercial interferences with investor-State contracts. It is therefore submitted that umbrella clauses must be seen as an enforcement mechanism for host State promises in general, independent of whether the host State has acted in its function as a sovereign or as a merchant. Accordingly, this section argues that umbrella clauses aim at empowering host States comprehensively in their contractual relationship with foreign investors in order for them to make credible commitments and thus comprehensively allow for private ordering of investor-State relations and efficient investor-State cooperation.

The primary function of umbrella clauses thus consists of remedying the loopholes the dualist framework has created in the enforcement of host State promises. In this sense, the clauses are portrayed as breaking with the dualist framework by establishing jurisdiction of treaty-based tribunals for claims that originate in breaches of municipal law, independent of whether these breaches are of a sovereign or a commercial nature. Not only can this view be supported within the structure and the objective of investment treaties; a broad understanding of umbrella clauses is also in accordance with the fundamental structure of international law. While a broad understanding of umbrella clauses breaks with the rigidity that some commentators and tribunals attach to the dualist conception of international law with its national/international law divide and the contract claim/treaty claim distinction, it does not break with the tradition and structure of international law as such. Instead this subsection also shows that there are manifold examples of pure contract claims in the international law realm. Finally, the historic emergence of umbrella clauses since the 1950s suggests a broad understanding covering both sovereign and commercial breaches of investor-State contracts.

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88. See Mann, *supra* note 32, at 574–75, for a discussion of these four different types of disputes concerning an investor-State contract.

## A. BREACHES OF A SOVEREIGN NATURE VERSUS COMMERCIAL BREACHES

The view that umbrella clauses only protect against breaches of contracts based on sovereign conduct or the abuse of governmental power has only found support in more recent scholarship<sup>89</sup> and particularly in two recent ICSID decisions in related cases decided by the same set of arbitrators. In *El Paso v. Argentina* and *Pan American v. Argentina*, the Tribunals held that it was “necessary to distinguish the State as a merchant from the State as a sovereign”<sup>90</sup> in the context of applying the umbrella clause. In *El Paso* the Tribunal considered that:

the umbrella clause in Article II of the BIT . . . will not extend the Treaty protection to breaches of an ordinary commercial contract entered into by the State or a State-owned entity, but will cover additional investment protections contractually agreed by the State as a sovereign—such as a stabilization clause—inserted in an investment agreement.<sup>91</sup>

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89. See Francesco Costamagna, *Investor' [sic] Rights and State Regulatory Autonomy: the Role of the Legitimate Expectation Principle in the CMS v. Argentina case*, 3 TRANSNAT'L DISP. MGMT. 10 (2006) (observing that the Tribunal's “finding provides further authority to the suggestion that umbrella clauses exclusively apply to governmental activities *iure imperii*”); Richard Happ, *Dispute Settlement under the Energy Charter Treaty*, 45 GERMAN Y.B. INT'L L. 331, 347–53 (2002) (discussing the minimum governmental measures that a State, as a sovereign entity, must take to ensure fair and equitable treatment and non-discrimination); Richard Happ & Noah Rubins, *Awards and Decisions of ICSID (W. Bank) Tribunals in 2004*, 47 GERMAN Y.B. INT'L L. 878, 921 (2004) (“[T]here appears to be growing support for the notion that before a breach of contract will amount to a breach of an investment treaty, the state must have acted in the exercise of its sovereign powers, rather than as an ‘ordinary’ contractual partner.”); Thomas W. Wälde, *Investment Arbitration under the Energy Charter: An Overview of Selected Key Issues based on Recent Litigation Experience*, in ARBITRATING FOREIGN INVESTMENT DISPUTES 193 (Norbert Horn ed., 2004); Wälde, *Contract Claims*, *supra* note 8; Thomas W. Wälde & Kaj Hobér, *The First Energy Charter Treaty Arbitral Award*, 22 J. INT'L ARB. 83, 94 (2005) (noting that the *SGS v. Philippines* tribunal avoided the question of whether “commitments to be observed” meant “investment contracts” with the State); Wälde, “*Umbrella Clause*” in *Investment Arbitration*, *supra* note 4, at 196 (“[D]isputes over contracts that display merely commercial- and contract-law elements will not fall under international law; such disputes do not involve the power of government . . .”).

90. *Pan American Energy LLC, and BP Argentina Exploration Co. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/03/13, and *BP America Production Co., Pan American Sur SRL, Pan American Fuegoína, SRL and Pan American Continental SRL v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/04/8 (consolidated claims), Decision on Preliminary Objections, para. 108 (July 27, 2006); *El Paso Energy Int'l Co. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/03/15, Decision on Jurisdiction, para. 79 (Apr. 27, 2006).

91. *El Paso*, ICSID Case No. ARB/03/15, at para. 81; *see also* *Sempra Energy*

As a consequence, the Tribunal considered that simple contract breaches could not be brought under the applicable treaty. It reasoned:

In the Tribunal's view, this umbrella clause does not extend its jurisdiction over any contract claims that the Claimants might present as stemming solely from the breach of a contract between the investor and the Argentine State or an Argentine autonomous entity. Moreover, in the Tribunal's view, it is especially clear that the umbrella clause does not extend [its jurisdiction] to any contract claims when such claims do not rely on a violation of the standards of protection of the BIT, namely, national treatment, MFN clause, fair and equitable treatment, full protection and security, protection against arbitrary and discriminatory measures, protection against expropriation or nationalisation either directly or indirectly, unless some requirements are respected.<sup>92</sup>

The Tribunal further considered in *Pan American* that "the 'umbrella clause' does not add anything in terms of the Tribunal's competence . . ."<sup>93</sup> Similarly, in *Sempra Energy v. Argentina*, the Tribunal was of the view that:

[t]he decisions dealing with the issue of the umbrella clause and the role of contracts in a Treaty context have all distinguished breaches of contract from Treaty breaches on the basis of whether the breach has arisen from the conduct of an ordinary contract party, or rather involves a kind of conduct that only a sovereign State function or power could effect.<sup>94</sup>

Other tribunals, by contrast, reject the distinction between commercial conduct and conduct *à titre de souverain* in the context of umbrella clauses. Although most cases concerning the violation of an umbrella clause did involve sovereign conduct, they did not require this as a constitutive element. The Tribunal in *Eureko v. Poland*, for example, explicitly rejected the contention that a distinction should be made between

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Int'l v. Argentine Republic, ICSID (W. Bank) Case No. ARB/02/16, Award, para. 109 (Sept. 28, 2007) (without, however, mentioning stabilization clauses as an example of the special contractual clauses the tribunal in *El Paso* had in mind).

92. *Pan American* (consolidated claims), at para. 112; *El Paso*, ICSID Case No. ARB/03/15, at para. 84.

93. *Pan American* (consolidated claims), at para. 114.

94. *Sempra Energy*, ICSID Case No. ARB/02/16, at para. 310; see also *CMS Gas Transmission Co. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/01/8, Award, para. 299 (May 12, 2005) ("The standard of protection of the treaty will be engaged only when there is a specific breach of treaty rights and obligations or a violation of contract rights protected under the treaty. Purely commercial aspects of a contract might not be protected by the treaty in some situations, but the protection is likely to be available when there is significant interference by governments or public agencies with the rights of the investor.").

governmental acts (*acta iure imperii*) and commercial acts (*acta iure gestiones*) of a State in connection with the application of an umbrella clause.<sup>95</sup>

The view that umbrella clauses protect against only governmental breaches is, however, unconvincing for a number of reasons. Apart from practical difficulties in distinguishing between governmental and purely commercial conduct,<sup>96</sup> the distinction, above all, disregards the importance of third-party dispute settlement for efficient investor-State cooperation and contracting. It disregards that, in order to make credible commitments, host State promises need to be protected not only against opportunistic behavior in the form of sovereign conduct, but also against breaches of a commercial character.

Furthermore, the inclusion of an umbrella clause in an investment treaty would be wholly superfluous since restrictions on the sovereign conduct of States, including their effect on investor-State contracts, are already established by other investors' rights, in particular the concepts of indirect expropriation and fair and equitable treatment.<sup>97</sup> Instead, the

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95. *Eureko*, Partial Award, *supra* note 6, paras. 115–34; *see also* Duke Energy Electroquil Partners & Electroquil S.A. v. Republic of Ecuador, ICSID (W. Bank) Case No. ARB/04/19, Award, para. 325 (Aug. 18, 2008) (suggesting that commercial conduct, such as delays in performing contractual obligations, delays in paying interest, and the poor implementation of a contract are sufficient to result in the violation of an umbrella clause); Noble Ventures, Inc. v. Romania, ICSID (W. Bank) Case No. ARB/01/11, Award, para. 51, para. 82 (Oct. 12, 2005) (discussing questions of attribution in the context of a claim based, *inter alia*, on a violation of an umbrella clause). Similarly, the requirement of governmental conduct was rejected by a number of commentators. *See* Ben Hamida, *supra* note 4, at 6 (“Ces traités ne distinguent pas entre les deux catégories de contrats. Ils s’appliquent aux investisseurs et aux investissements, notions entendues largement. Par ailleurs, une telle distinction est difficile à mettre en œuvre au vu des controverses qui entourent l’identification du contrat d’Etat.”); Kunoy, *supra* note 4, at 291–93; Schramke, *supra* note 4, at 22–23; Zolia, *supra* note 4, at 34–36. *Cf.* Grigera Naon, *Les contrats d’Etat: quelques réflexions*, 3 REVUE DE L’ARBITRAGE 667, 686 (2003) (“Les violations d’un BIT sont attribuées à l’Etat signataire dans la mesure où, selon le droit international, l’activité des divisions politiques, autorités, organes ou entités qu’il contrôle ou administre lui est imputable, ce qui peut arriver même pour leur activité iure gestions.”).

96. *See, e.g.*, *Noble Ventures*, ICSID Case No. ARB/01/11, at para. 82 (noting that there is a “widespread consensus” that there is no common understanding of what a public act is); Gill et al., *supra* note 1, at 407 (pointing to practical difficulties). *But see* Walde, *Contract Claims*, *supra* note 8 (specifying criteria for the distinction, while recognizing that drawing the distinction is “no easy task”).

97. *Cf.* Gaffney & Loftis, *supra* note 4, at 12; Zolia, *supra* note 4, at 34–35 (“Breaches of contract that are motivated by non-commercial considerations create international state responsibility even in the absence of an ‘umbrella clause’.”). Therefore, as a matter of logic, ‘umbrella clauses’ should offer a broader protection



principle of effective interpretation mandates interpreting umbrella clauses so as to give them their proper scope of application, rather than to make them effectively superfluous.<sup>98</sup> Certainly, if umbrella clauses are “meant to add something to—rather than subtract something from—the protection otherwise enjoyed by contracts of investors with governments under customary international law and the earlier investment disciplines,”<sup>99</sup> an interpretation limiting the clauses to breaches of investor-State contracts by governmental conduct is not convincing. Instead, replicating categories that govern the interpretation of investment treaty standards such as fair and equitable treatment or indirect expropriation in the interpretation of umbrella clauses—namely the distinction between governmental and commercial conduct, between contract claim and treaty claim—is an exercise that excludes any autonomous scope of application of an umbrella clause.<sup>100</sup>

Conversely, the application of umbrella clauses to any type of breach of a host State promise, whether governmental or commercial, does not make other substantive obligations of investment treaties “substantially superfluous,” as the Tribunals in *SGS v. Pakistan* and *El Paso v. Argentina* argued.<sup>101</sup> In the view of the Tribunal in *SGS v. Pakistan*, a broad interpretation of umbrella clauses would relieve investors of the “need to demonstrate a violation of those substantive treaty standards if a simple breach of contract, or of municipal

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against all breaches, whether governmental or not.”).

98. *Noble Ventures*, ICSID Case No. ARB/01/11, at paras. 50–52; *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, ICSID (W. Bank) Case No. ARB/02/6, Decision on Objections to Jurisdiction, para. 116 (Jan. 29, 2004); *Eureko*, Partial Award, *supra* note 6, paras. 248–49. See *Asian Agric. Products Ltd. (AAPL) v. Democratic Socialist Republic of Sri Lanka*, ICSID (W. Bank) Case No. ARB/87/3, Award, para. 40 (June 27, 1990), on the doctrine of effective interpretation of international treaties, specifically in the investment treaty context.

Nothing is better settled, as a canon of interpretation in all systems of law, than that a clause must be so interpreted as to give it a meaning rather than so as to deprive it of meaning. This is simply an application of the wider legal principle of ‘effectiveness’ which requires favouring the interpretation that gives to each treaty provision ‘effet utile’.

*Id.* (internal citation omitted).

99. Wälde, “Umbrella Clause” in *Investment Arbitration*, *supra* note 4, at 206 (reaching, however, the contrary conclusion to the one suggested in the present article).

100. See cases cited *supra* notes 80–87.

101. *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, ICSID (W. Bank) Case No. ARB/01/13, Decision on Objections to Jurisdiction, para. 168 (Aug. 6, 2003).

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.”<sup>102</sup>

Likewise, the Tribunal in *El Paso v. Argentina* considered that:

it would be sufficient to include a so-called “umbrella clause” and a dispute settlement mechanism, and no other articles setting standards for the protection of foreign investment in any BIT. If any violation of any legal obligation of a State is *ipso facto* a violation of the treaty, then that violation needs not amount to a violation of the high standards of the treaty of “fair and equitable treatment” or “full protection and security.”<sup>103</sup>

The Tribunal’s argument disregards that other investors’ rights—including fair and equitable treatment, indirect expropriation, and nondiscrimination—concern obligations of host States that are normally not addressed by investor-State contracts.<sup>104</sup> Host States usually do not promise, for example, nondiscrimination in contracts. Already from this point of view, umbrella clauses do not make other investors’ rights superfluous. The argument further disregards that not all foreign investment projects are based on a contract between a foreign investor and a host State. Instead, foreign investment also takes place by the unfolding of economic activity on the basis of the host State’s general legislation or by capital investment in foreign companies. These types of investments are therefore not covered by the scope of application of umbrella clauses because no investor-State contracts or similar instruments serve as a basis of the investor’s economic activity. In fact, these types of foreign investments regularly generate investment treaty disputes that are exclusively concerned with the conformity of changes in the host State’s general regulatory framework or administrative conduct and do not involve breaches of promises made vis-à-vis the foreign investor.<sup>105</sup>

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102. *Id.*

103. *El Paso Energy Int’l Co. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/03/15, Decision on Jurisdiction, para. 76 (Apr. 27, 2006).

104. Schreuer, *supra* note 4, at 253; see also *Eureko*, *supra* note 6, para. 258 (“[R]eliance by the Tribunal in *SGS v. Pakistan* on the maxim *in dubio mitius* so as to effectively presume that sovereign rights override the rights of a foreign investor could be seen as a reversion to a doctrine that has been displaced by contemporary customary international law . . .”).

105. See generally *International Thunderbird Gaming Corp. v. The United Mexican States*, UNCITRAL/NAFTA, Arbitral Award (Jan. 26, 2006) (alleging that Mexico breached its NAFTA obligations); *Methanex Corp. v. United States of America*, UNCITRAL/NAFTA, Final Award (Aug. 3, 2005) (alleging that the United

Finally, the distinction between commercial and sovereign conduct is also unconvincing from an economic perspective. In fact, compliance with the host State's original promises vis-à-vis a foreign investor can be as effectively eviscerated by changing the governing law of an investor-State contract as by the bad faith reliance on ambiguities of the contract in question, the outright refusal to pay, or similar commercial breaches. From an economic perspective that views the performance of a contract in terms of the gains from cooperation, distinguishing between breaches of a commercial and a governmental nature is therefore not very convincing, as the effects can be equally destructive for the contractual equilibrium. In both cases of commercial or sovereign conduct, the lack of third-party dispute settlement can prevent States from making credible commitments in investor-State contracts and thus increase the costs of investor-State cooperation. It is thus difficult to justify why a dispute about the interpretation of a contractual clause that is decisive as to whether a party has to pay several millions of dollars should be a matter outside the scope of international dispute settlement and investment treaty arbitration, while the confiscation of an automobile, a thoroughbred horse, two Kashan carpets and other household items, a Rolex watch and other jewelry with a combined net worth of only a few tens of thousands of dollars would be within the limits of traditional international law dispute resolution.<sup>106</sup>

In a slightly different context, international law takes the same perspective on the indistinguishability between governmental and commercial conduct, namely as regards the

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States breached its NAFTA obligations); *S.D. Myers, Inc. v. Canada*, UNICTRAL/NAFTA Final Award (Dec. 30, 2002) (alleging that Canada breached its NAFTA obligations); *Methanex Corp. v. United States of America*, UNCITRAL/NAFTA, Partial Award (Aug. 7, 2002); *Middle East Cement Shipping and Handling Co. S.A. v. Arab Republic of Egypt*, ICSID (W. Bank) Case No. ARB/99/6, Award, (Apr. 12, 2002) (involving Egypt withholding approval to re-export assets, in violation of Egypt's own investment law); *S.D. Myers, Inc. v. Canada*, UNCITRAL/NAFTA, Partial Award (Nov. 13, 2000); *Am. Mfg. & Trading, Inc. v. Republic of Zaire*, ICSID (W. Bank) Case No. ARB/93/1, Award, (Feb. 21, 1997) (involving Zaire not fulfilling its obligations of protection in violation of a BIT); *Loewen Group, Inc. and Raymond L. Loewen v. United States of America*, ICSID Case No. ARB(AF)/98/3, Award (June 26, 2003) (alleging that the United States breached its NAFTA obligations); *Asian Agric. Products Ltd. (AAPL) v. Democratic Socialist Republic of Sri Lanka*, ICSID (W. Bank) Case No. ARB/87/3, Award (June 27, 1990) (alleging that Sri Lanka did not fulfill its security obligations under a BIT).

106. See *Leonard and Mavis Daley v. Iran*, 18 Iran-U.S. Cl. Trib. Rep. 232, 234-36 (1989).

rules on attribution of conduct to the State under the international law rules on State responsibility.<sup>107</sup> For instance, with respect to the conduct of a State organ under Art. 4 of the International Law Commission's *Articles on State Responsibility*, the relevance of the distinction between commercial and sovereign acts has been expressly denied by the Commission. As the official commentary on the Articles states: "[i]t is irrelevant for the purposes of attribution that the conduct of a State organ may be classified as 'commercial' or as '*acta iure gestionis*.'"<sup>108</sup> The commentary further stresses that "entry into or breach of a contract by a State organ is nonetheless an act of the State for the purposes of article 4,"<sup>109</sup> just as traditional sovereign conduct is.

Presumably, the idea underlying the distinction between governmental and commercial conduct is that only sovereign breaches of an investor-State contract constitute a political risk, whereas commercial breaches are equally possible when contracting with a private actor and thus do not increase the risk of contracting with a sovereign.<sup>110</sup> Yet the difference between the host State and normal private parties, even as regards commercial breaches, is that the latter are not their own judges in their own courts. Unlike private parties, the host State is able to control the way the law is applied by its own courts and is therefore not able to provide independent third-party dispute settlement that would enable it to make credible commitments.<sup>111</sup> The situation between contracts between private parties and investor-State contracts is, therefore, not comparable.<sup>112</sup>

Interpreting umbrella clauses restrictively does not only

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107. See also James Crawford, *Treaty and Contract in Investment Arbitration*, TRANSNAT'L DISP. MGMT., Jan. 2008, at 6–7.

108. JAMES CRAWFORD, THE INTERNATIONAL LAW COMMISSION'S ARTICLES ON STATE RESPONSIBILITY, 96 (2002).

109. *Id.* (citing Swedish Engine Drivers Union Case, 20 Eur. Ct. H.R. (ser. A) at 14 (1976); Schmidt and Dahlström, 21 Eur. Ct. H.R. (ser. A) at 15 (1976)). The ILC commentary to the *Articles on State Responsibility* further adds that "[t]he irrelevance of the classification of the acts of State organs as *iure imperii* or *iure gestionis* was affirmed by all those members of the Sixth Committee who responded to a specific question on this issue from the Commission . . . ." CRAWFORD, *supra* note 108, at 96 n.118.

110. This proposition is, however, supported by those tribunals and commentators that endorse the dualist distinction between the State as a regulator and the State as a merchant.

111. See *supra* Part II.B.1

112. See Mayer, *supra* note 19, at 5.

reduce the ability of host States to make credible commitments and therefore lessen efficient cooperation between investors and host States. It is also unnecessary with regard to the feared flood of disputes under investment treaty arbitration. First, a broad interpretation of umbrella clauses that allows bringing any claim for the violation of an investor-State contract would not allow investors to bring every commercial dispute or every dispute about the violation of municipal law within the ambit of investment treaty arbitration as some commentators and tribunals fear.<sup>113</sup> Instead, the limits imposed on investment treaty arbitration by the scope of applicability of the relevant investment treaty and the subject matter jurisdiction of the ICSID Convention remain relevant. Both limit recourse to arbitration under an investment treaty to *investment*-related contracts.<sup>114</sup> By contrast, contractual disputes arising out of simple sales contracts, for instance, will not be upgraded by means of an umbrella clause to a dispute that can be brought under an investment treaty.<sup>115</sup> Umbrella clauses do not affect

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113. See *El Paso Energy Int'l Co. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/03/15, Decision on Jurisdiction, para. 72 (Apr. 27, 2006); *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, ICSID (W. Bank) Case No. ARB/01/13, Decision on Objections to Jurisdiction, para. 166 (Aug. 6, 2003) *Cf. infra* note 117.

114. See Gaffney & Loftis, *supra* note 4, at 13–15 (on the requirement of the investment-related nature of the investor-State contract with respect to the host State's promise vis-à-vis the foreign investor); Schreuer, *supra* note 4, at 253. On Article 25 of the ICSID Convention as a jurisdictional limit to investment-related disputes, see, for example, Burkhard Schöbener & Lars Markert, *Das International Centre for Settlement of Investment Disputes (ICSID)*, 105 ZEITSCHRIFT FÜR VERGLEICHENDE RECHTSWISSENSCHAFT [ZVGLRWISS] 65, 81 *et seq.* (2006) (pointing out that even if the definition of investment is broad enough to cover simple contractual claims, for instance out of a simple sales contract, the definition of investment in Art. 25 ICSID draws an outer limit to the definition of investment by IIA or by the parties to an investment agreement even if they contractually submitted a dispute by a choice of forum clause to the exclusive jurisdiction of ICSID). See also *Joy Mining Mach. Ltd. v. Egypt*, ICSID (W. Bank) Case No. ARB/03/11, Decision on Jurisdiction, para. 50 (July 30, 2004) (“The parties to a dispute cannot by contract or treaty define as investment, for the purpose of ICSID jurisdiction, something which does not satisfy the objective requirements of Article 25 . . . and its reliance on the concept of investment, even if not specifically defined, would be turned into a meaningless provision.”); Carolyn Lamm, *Jurisdiction of ICSID*, 6 ICSID REV.- FOREIGN INV. L. J. 462, 475 (1991).

115. See also the example given in Thomas W. Wälde, *International Investment under the 1994 Energy Charter Treaty*, J. WORLD TRADE L., Oct. 1995 at 48, of a French village breaching a sales contract with a foreign petroleum company. Such constellations would, however, be outside of the scope of the umbrella clause not because the wording of the clause is overly broad and requires restrictive interpretation, but because a simple sales contract is not covered by the notion of

the classification of a contract as investment-related. They merely allow breaches of investment-related contracts that qualify as investment under the relevant investment treaty to be brought under the treaty-based dispute settlement procedure.<sup>116</sup>

Allowing claims for commercial breaches of investment-related contracts to be brought before treaty-based tribunals as a violation of an umbrella clause does not run counter to the nature of investment arbitration either.<sup>117</sup> Instead, the ICSID Convention has not exclusively, nor even primarily, been designed for disputes to be heard under investment treaties, but rather intended to establish a forum for the settlement of disputes concerning the interpretation and breach of contracts between investor and States based on a contractual arbitration clause.<sup>118</sup> In fact, the earliest disputes under the ICSID Convention have all been contract-based disputes.<sup>119</sup>

Nor does the settlement of contractual investor-State disputes under investment treaties threaten the sustainability of the system of investment arbitration because of an unmanageable increase in the number of disputes. Instead, the structure of investment arbitration based on *ad hoc* arbitration panels allows setting up third-party dispute resolvers in a flexible manner whenever the need arises. Unlike a standing court with a fixed number of judges, the institutional dispute settlement structure is therefore able to adapt flexibly as the demand for dispute resolution by the parties arises. Clogs of the docket or judicial backlog are therefore not a concern that should militate for a restrictive interpretation of umbrella

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investment and is therefore outside of the scope of application of umbrella clauses *ratione materiae*.

116. See *infra* Part V.A.

117. But see Wälde, *Contract Claims*, *supra* note 4, at 226 (“If the *pacta sunt servanda* clause applied to ‘any contract’ of foreigners with any governmental entity or State enterprise, then there is a risk that BIT tribunals would indeed become courts of first instance or an appeal authority for any of the innumerable contract disputes likely to arise.”).

118. See Aron Broches, *The Convention on the Settlement of Investment Disputes between States and Nationals of Other States*, 136 RECUEIL DES COURS 331, 342–48 (1972-II) (on the historical backdrop of establishing the ICSID Convention, which consisted in a lack of dispute settlement mechanisms); see also *id.* at 352–54 (pointing out that consent to arbitration under the ICSID Convention could be given either in an investor-State contract, in an investment treaty, or in domestic legislation).

119. See CHRISTOPH SCHREUER, *THE ICSID CONVENTION: A COMMENTARY*, 89–94 (2001).

clauses. On the contrary, what seems fully sufficient to serve as a filter for access to investment treaty arbitration is the cost risk connected to potential claims.<sup>120</sup> Only when a dispute is sufficiently economically valuable will an investor choose to initiate arbitration and incur the cost risk. This should effectively bar trivial disputes from investment treaty arbitration.<sup>121</sup>

For the above mentioned reasons, distinctions between sovereign and commercial breaches of investor-State contracts and similar instruments should be discarded. Consequently, umbrella clauses have to be viewed as a breakage with traditional notions of State sovereignty and the insufficient protection of investor-State contracts under customary international law. Their function does not consist in merely declaring a state of customary international law, but rather in “introduc[ing] an exception to the general separation of States obligations under municipal and international law.”<sup>122</sup> They establish the jurisdiction under the dispute settlement mechanism of investment treaties by allowing for a cause of action under international law based on the breach of an investor-State promise by the host State. If umbrella clauses were merely declaratory of customary international law, by clarifying that contractual rights are subject to expropriation, the clauses would be wholly superfluous, as the prohibition of direct and indirect expropriation would already protect investors against host State conduct that interferes with the investor’s rights *à titre de souverain*. Accordingly, the primary function of the umbrella clause is to provide for the enforcement of such promises independent of the governing law by opening recourse to an international forum for the settlement of disputes

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120. See generally Stephan W. Schill, *Arbitration Risk and Effective Compliance*, 7 J. WORLD INV. & TRADE 653 (2006) (noting that one-way, pro-investor cost-shifting schemes could lead to over-litigation, but shifting costs against investors who bring spurious claims would be a sufficient barrier).

121. In this sense, see also Rudolf Dolzer, *Schirmklauseln in Investitionsschutzverträgen*, in VÖLKERRECHT ALS WERTORDNUNG – FESTSCHRIFT FÜR CHRISTIAN TOMUSCHAT/COMMON VALUES IN INTERNATIONAL LAW – ESSAYS IN HONOUR OF CHRISTIAN TOMUSCHAT, 281, 295 (Pierre-Marie Dupuy et al. eds., 2006); Zolia, *supra* note 4, at 48. It is therefore not feasible to exclude certain categories as insignificant breaches of host State promises, such as disputes over interest due to a delay in performance. See Schreuer, *supra* note 4, at 253. To the extent the cost risk merits initiating investor-State arbitration, the dispute is not insignificant from an economic perspective.

122. Noble Ventures, Inc. v. Romania, ICSID (W. Bank) Case No. ARB/01/11, Award, para. 55 (Oct. 12, 2005).

about the obligations arising under the host State's promise vis-à-vis foreign investors. Umbrella clauses thus stabilize investor-State relations *ex post* by offering enforcement mechanisms for investment-related host State promises, independent of whether the breach is of a sovereign or a commercial nature.

## B. DISSOLUTIONS OF THE DUALIST FRAMEWORK IN INTERNATIONAL DISPUTE RESOLUTION

What the more restrictive line of interpretation of umbrella clauses also disregards in its strict emphasis on the national/international law divide is that even under customary international law the distinction between contract claims and treaty claims, respectively municipal law and international law, was never as categorical as the restrictive approach purports. By contrast, international law has always accepted that States can submit claims for the violation of municipal law to international law dispute resolution, including inter-State proceedings. Similarly, modern investment treaties often allow for the settlement of both treaty and contract claims based on broadly worded arbitration clauses. Both of these developments suggest that the distinction between claims for the violation of domestic law and claims for the violation of international law does not constitute a rigid distinction that would need to be prolonged by a restrictive interpretation of umbrella clauses that limits the clauses' scope of application to sovereign breaches of investor-State contracts.

### 1. *Contract Claims in Classical Inter-State Dispute Settlement*

While customary international law only offers a limited scope of protection to investor-State contracts, it has never prevented States from submitting pure contract claims to inter-State dispute resolution. Although States have traditionally been reluctant to espouse claims by their nationals for simple breaches of contract by means of diplomatic protection,<sup>123</sup> customary international law did not prohibit the espousal of such claims. In fact, abundant State practice and older

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123. The United States, for example, had a long-standing policy not to intervene with force based on the breach of an investor-State contract. The reasons for this were largely of a "political" nature. The fact that the investor had entered freely into the agreement and voluntarily accepted the risk associated with contractual breaches played a role. In addition, not upsetting inter-State relations was often important. See Jennings, *supra* note 58, at 159, 164, 179–81.



jurisprudence clearly confirms that States were not prevented from solving disputes concerning the breach of contracts between States and foreign nationals absent any independent breach of international law in an international forum. These cases further confirm that international law did not categorically insist on the distinction between contract claims and treaty claims, or even, excluded contract claims from the ambit of international dispute settlement altogether.<sup>124</sup>

In *Singer Sewing Machine*, for example, the American-Turkish Claims Commission upheld a claim by an American company for the payment of the purchase price of sewing machines sold to a Turkish Ministry with the following considerations:

It cannot be said that the law of nations embraces any 'Law of Contracts' such as is found in the domestic jurisprudence of nations. International Law does not prescribe rules relative to the forms and legal effect of contracts, but that law may be considered to be concerned with the action authorities of a government may take with respect to contractual rights. It is believed that in the ultimate determination of responsibility under international law, application can properly be given to principles of law with respect to confiscation, and that the confiscation of the property of an alien is violative of international law. If a government agrees to pay money for commodities and fails to make payment, the view may be taken that the purchase price of the commodities has been confiscated, or that the commodities have been confiscated, or that property rights in a contract have been destroyed or confiscated.<sup>125</sup>

While the legal analysis in the *Singer* case remains in the

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124. That these cases were mostly settled on the basis of an inter-State *compromis* that established the jurisdiction of an international court of tribunal does not vitiate, but rather confirms, that the general structure of international law was not opposed to such a mingling of national and international law. *But cf.* Mann, *supra* note 32, at 572 n.2 (stating that it is sufficient to bring a claim before an international tribunal that arises under municipal law if the dispute is submitted by way of *compromis*).

125. The United States of America on behalf of Singer Sewing Machine Company v. The Republic of Turkey, in AMERICAN-TURKISH CLAIMS SETTLEMENT, 491 (Fred K. Nielsen preparer, 1937) (citing the Cook Case (U.S. v. Mex.), 4 Rep. Int'l Arb. Awards 213 (1951)). The Cook Case involved the refusal of the Mexican Government to pay the purchase price for 5,000 school benches delivered by an American company under a contract governed by Mexican law awarded to the company after a public bidding procedure. Although the contract was originally awarded to the American company, the contract was, at the request of the Mexican Government, concluded with a representative of the company in his own name. The claim was ultimately dismissed by majority vote because Mexican law, as the law governing the contractual relationship between the parties, did not give the company a right to sue under the contract because it was not a party thereto.

traditional dualist framework of international law by assuming the necessity of an expropriatory conduct on behalf of the host State,<sup>126</sup> the decision did not require the breach to be based on sovereign conduct. Instead, the simple refusal to pay a contractually due sum was a sufficient basis for finding in favor of the foreign national based on the law of expropriation. This decision, therefore, contrasts strikingly with the decisions in *SGS v. Philippines* or *Waste Management v. Mexico* that both considered simple non-performance of contractual obligations, such as nonpayment, as insufficient for constituting expropriation.<sup>127</sup>

Similarly, the *Landreau* claim<sup>128</sup> concerned a dispute of a quasi-contractual nature arising out of the refusal of the Peruvian Government to pay royalties for the discovery of Guano deposits to an American national. Although the award was not based on breach of a contract, the Commission granted relief on the basis of *quantum meruit*, a quasi-contractual remedy. Again, it is interesting to note that an international dispute settlement body entertained the case, although a violation of international law separate from a breach of the quasi-contractual relationship between the Peruvian government and the American national was not in question.

Various cases were also entertained by the Mexican Claims Commissions in the 1920s and 1930s that exclusively involved claims for breaches of contracts governed by municipal law.<sup>129</sup> The *Illinois Central Railroad* case,<sup>130</sup> for example, concerned a claim for the payment of money for the delivery of railroad engines sold to the Mexican Government. The Respondent moved to have the claim dismissed in arguing that there was no question of the government's responsibility under international law. The Commission, however, in interpreting the United States-Mexican General Claims Convention that provided jurisdiction for "all claims . . . for losses or damages suffered by persons or by their properties"<sup>131</sup> emphasized that:

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126. Cf. *The United States of America on behalf of Ina M. Hofmann and Dulce H. Steinhardt v. The Republic of Turkey*, in *AMERICAN-TURKISH CLAIMS SETTLEMENT*, *supra* note 125, at 286.

127. See *supra* notes 85–87 and accompanying text.

128. *Landreau (U.S. v. Peru)* 1 R. Int'l Arb. Awards 352 (1922).

129. See A. H. FELLER, *THE MEXICAN CLAIMS COMMISSIONS* 173 *et seq.* (Macmillan Co. 1935).

130. *Ill. Cent. R.R. Co. v. United Mexican States*, 4 R. Int'l Arb. Awards 134 (1926) (*Illinois Central Railroad Case*).

131. Convention of Sept. 8, 1923, United States-Mexican General Claims

[c]laims as between a citizen of one country and the government of another country acting in its civil capacity . . . too are international in their character, and they too must be decided 'in accordance with the principles of international law', even in cases where international law should merely declare the municipal law of one of the countries to be applicable.<sup>132</sup>

The Commission therefore expressly confirmed that international law did not restrict States in submitting claims that exclusively concerned breaches of contracts governed by municipal law to inter-State dispute settlement, even if the host State acted in its civil capacity and breached the contract by means of purely commercial conduct.<sup>133</sup>

Finally, the PCIJ entertained two cases that involved inter-State disputes concerning claims for breaches of bond agreements between private individuals and a foreign State that were governed by French law. Both the *Serbian Loans* case and the *Brazilian Loans* case involved questions of contract interpretation and did not concern independent breaches of inter-State obligations. At issue was instead whether bonds drawn in "gold francs" were repayable on a gold basis or could be effectuated in paper francs based on the nominal value of the bonds, after France had abandoned the gold standard.

Having been submitted to the PCIJ on the basis of a Special Agreement, the Court first addressed the question of jurisdiction. It considered that the dispute needed to be of an "international character" under the Court's Statute.<sup>134</sup> Against two dissenting opinions that argued that the international character of a dispute actually required "show[ing] that the subject matter of the dispute was governed by international law and that the purpose of the decision was to enforce principles or apply instruments of international law,"<sup>135</sup> the Court affirmed its

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Commission, art. I, as reprinted in Feller, *supra* note 129, at 322-24.

132. *Illinois Central Railroad Case*, 4 R. Int'l Arb. Awards 134 (1926).

133. Similarly, in *The United States of America on Behalf of John A. McPherson v. The United Mexican States*, as reprinted in General Claims Comm'n (U.S. v. Mex.), Opinions of the Commissioners, 325-29 (1927), the American-Mexican Claims Commission ordered the government to pay the sums due under a postal money order without raising the question of whether the non-payment of the amount due did, apart from constituting a breach of contract, constitute a separate breach of international law.

134. *Serbian Loans*, *supra* note 49, at 16; see also *Payment in Gold of Brazilian Federal Loans Contracted in France* (Fr. v. Braz.), 1929 P.C.I.J. (ser. A) No. 20/21, Judgment no. 15, at 93-101 (July 12).

135. *Serbian Loans*, *supra* note 49, at 62 (Pessoa, dissenting); see also *id.* at 76 (Novacovitch, dissenting).

jurisdiction, holding that when “two States have agreed to have recourse to the Court, the latter’s duty to exercise its jurisdiction cannot be affected, in the absence of a clause in the Statute on the subject, by the circumstance that the dispute relates to a question of municipal law . . . .”<sup>136</sup>

Thus clarifying that even if a contractual relationship between the national of one State and a foreign State was exclusively governed by municipal law, international law allowed the home State to exercise diplomatic protection, the Court observed:

The controversy submitted to the Court in the present case . . . solely relates to the existence and extent of certain obligations which the Serbian State is alleged to have assumed in respect of the holders of certain loans. It therefore is exclusively concerned with relations between the borrowing State and private persons, that is to say, relations which are, in themselves, within the domain of municipal law.

It is however to be noted that the question whether the manner in which the Serb-Croat-Slovene Government is conducting the service of its loans is in accordance with the obligations accepted by it, is no longer merely the subject of a controversy between that Government and its creditors. When the holders of the Serbian loans, considering that their rights were being disregarded, appealed to the French Government, the latter intervened on their behalf with the Serb-Croat-Slovene Government. . . . As from this point, therefore, there exists between the two Governments a difference of opinion which, though fundamentally identical with the controversy already existing between the Serb-Croat-Slovene Government and its creditors, is distinct therefrom; for it is between the Governments of the Serb-Croat-Slovene Kingdom and that of the French Republic, the latter acting in the exercise of its rights to protect its nationals.<sup>137</sup>

Although the dispute was “fundamentally identical with the controversy already existing between the Serb-Croat-Slovene Government and its creditors”<sup>138</sup> and “relate[d] exclusively to a *nexus* of municipal law between the Serb-Croat-Slovene State as borrower and the holders of certain States,”<sup>139</sup> the PCIJ did not consider international law to prevent States from litigating such disputes in an inter-State forum. Likewise, the application of domestic law was not an obstacle to the jurisdiction of an inter-State dispute settlement mechanism.

In sum, neither the PCIJ nor other inter-State dispute

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136. *Id.* at 19.

137. *Id.* at 18.

138. *Id.* at 18.

139. *Id.* at 20.

settlement bodies found a rule of international law that prevented States from bridging the difference between contract claims and treaty claims by granting diplomatic protection and submitting contract claims to international dispute settlement. Much to the contrary, the case law confirms that international law did not prevent States from espousing claims of their nationals against the host State, even in a case where the alleged breach only concerned a violation of national law. In addition, the pertinent decisions do not reflect a presumption against litigating breaches of municipal law in inter-State proceedings as long as the jurisdictional basis can be reasonably interpreted as covering claims for the breach of municipal law or commercial breaches of investor-State contracts. This case law and the underlying State practice therefore call into question the restrictive approach to interpreting umbrella clauses that elevates the contract claim/treaty claim distinction into a doctrine of international law that could not be undone by international treaties.

## 2. Broadly Worded Arbitration Clauses in Investment Treaties

That the national/international law divide is not as strict as suggested by those who support a restrictive interpretation of umbrella clauses can also be seen in broadly worded arbitration clauses under many investment treaties that enable investors to bring “any dispute relating to investments.”<sup>140</sup> Arbitral tribunals have interpreted such clauses as allowing foreign investors to bring claims based on the violation of investor-State contracts without alleging any separate violation of the investment treaty in question, such as fair and equitable treatment or indirect expropriation.

The Tribunals in *Salini v. Morocco*<sup>141</sup> and *Consortium RFCC v. Morocco*,<sup>142</sup> for example, had to consider the scope of Art. 8 of

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139. For a discussion of broad arbitration clauses, see Jörn Griebel, *Jurisdiction over “Contract Claims” in Treaty-Based Investment Arbitration on the Basis of Wide Dispute Settlement Clauses in Investment Agreements*, 4 TRANSNAT'L DISP. MGMT. (Sept. 2007); Jörn Griebel, *Die Einbeziehung von “contract claims” in internationale Investitionsstreitigkeiten über Streitbeilegungsklauseln in Investitionsschutzabkommen*, 4 ZEITSCHRIFT FÜR SCHIEDSVERFAHREN [SCHIEDSVZ]/GERMAN ARB. J. 306 (2006). See also Gaffney & Loftis, *supra* note 4, at 13–15.

141. *Salini Costruttori S.p.A. and Italstrade S.p.A. v. Kingdom of Morocco*, ICSID (W. Bank) Case No. ARB/00/4, Decision on Jurisdiction (July 23, 2001).

142. *Consortium RFCC v. Morocco*, ICSID (W. Bank) Case No. ARB/00/6,

the Italian-Moroccan BIT that granted jurisdiction for “[a]ll disputes and differences, including disputes related to the amount of compensation due in the event of expropriation, nationalisation, or similar measures, between a Contracting Party and an investor of the other Contracting Party concerning an investment of the said investor on the territory of the first Contracting Party . . . .”<sup>143</sup>

Both Tribunals considered that this provision did not limit the investor to bringing claims for the violation of international law but “compels the State to respect the jurisdiction offer in relation to violations of the Bilateral Treaty and any breach of a contract that binds the State directly.”<sup>144</sup> Both tribunals thus recognized that broadly worded arbitration clauses in BITs could establish jurisdiction of treaty-based tribunals for simple contract claims.<sup>145</sup>

Like the older decisions in inter-State proceedings discussed above,<sup>146</sup> the inclusion of broadly worded arbitration clauses in investment treaties shows that the distinction between contract claims and treaty claims is not categorical and insurmountable. On the contrary, as long as arbitration clauses in investment treaties encompass both types of claims, contract claims can be entertained by dispute resolution bodies established on the basis of an international treaty. The practice of States to include broadly worded arbitration clauses in investment treaties therefore also confirms that international law is not built upon a rigid distinction between contract claims and treaty claims that

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Decision on Jurisdiction (July 16, 2001).

143. *Salini v. Morocco*, ICSID Case No. ARB/00/4, at para. 15.

144. *Id.* para. 61; *see also Consortium RFCC*, ICSID Case No. ARB/00/6, at para. 68.

145. In the concrete cases, the Tribunals declined jurisdiction because they assumed that only contracts with the central government were covered, not however, contracts with independent State agencies. *See Salini v. Morocco*, ICSID Case No. ARB/00/4, at paras. 59–63; *Consortium RFCC*, ICSID Case No. ARB/00/6, at paras. 67–71; *Impregilo S.p.A. v. Islamic Republic of Pakistan*, ICSID (W. Bank) Case No. ARB/03/3, Decision on Jurisdiction, paras. 211 *et seq.* (Apr. 22, 2005). *But see Salini Costruttori S.p.A. and Italstrade S.p.A. v. The Hashemite Kingdom of Jordan*, ICSID Case No. ARB/02/13, Decision on Jurisdiction, paras. 97 *et seq.* (Nov. 29, 2004); *Compañía de Aguas del Aconquija S.A. & Vivendi Universal v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/97/3, Decision on Annulment, para. 55 (July 3, 2002) (discussing claims against a province under Article 8 of the BIT). *See also SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, ICSID (W. Bank) Case No. ARB/02/6, Decision on Objections to Jurisdiction, paras. 131–132 (Jan. 29, 2004) (accepting jurisdiction over contract claims based on broad arbitration clauses).

146. *See supra* Part 0.

would shield contract claims from treaty-based dispute settlement.

In sum, there is sufficient State practice to support the conclusion that, in principle, customary international law did and does not prevent States from espousing the claim for breach of contract by one of its nationals against the host State independent of the existence of an independent breach of international law. Consequently, there is no room for a presumption of interpreting investment treaties, including umbrella clauses, restrictively so as to uphold the allegedly strict distinction between contract claims and treaty claims. Such a presumption finds no basis in State practice or international jurisprudence. Instead, the history of contract claims in international dispute settlement fora as well as the inclusion of broadly worded arbitration clauses in modern investment treaties illustrate that the main problem in the protection of investor-State contracts was more caused by the lack of ready dispute settlement mechanisms for contract claims than by any firm and dogmatic distinction between claims based on international and those based on national law.<sup>147</sup>

### C. THE HISTORICAL PERSPECTIVE ON UMBRELLA CLAUSES

That the function of umbrella clauses is to establish enforcement mechanisms for host State promises, independent of whether a breach was of commercial or sovereign character, is also supported by the historical background of the emergence of umbrella clauses.<sup>148</sup> Arguably the first umbrella clause was included in an Agreement between the United Kingdom and Peru from 1921 that created an *ad hoc* tribunal for the resolution of a dispute over a mineral concession granted to a British-owned company. The object of this agreement was not to change the applicable law of the concession but to “elevate the status of the resulting award from that of an award simply

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147. Cf. Jennings, *supra* note 58, at 165 (arguing that the view denying any genuine protection to State contracts by international law largely stems from a misperception about the relationship between substantive and procedural law. It thus “fall[s] into the error of erecting the absence of a remedy into a dogma, and suppos[es] that where no remedy is, none could be. This easily ripens into the error of continuing to suppose that no remedy can exist even where one is already provided.”).

148. For more information on this and the following, see Sinclair, *supra* note 2, at 412–13, which provides an excellent study on the historical development of umbrella clauses.

between the investor and Peru, to an award in which Peru owed to the United Kingdom an international obligation to comply with its terms, and so to render its enforcement a matter of international law."<sup>149</sup> The agreement therefore exclusively served procedural purposes with respect to the effective enforcement of an award rendered by the tribunal.

The aspect of providing enforcement for a contractual agreement between a foreign investor and the host State was again the main concern in the settlement negotiations between the Anglo-Iranian Oil Company (AIOC) and the Iranian Government in the early 1950s, after AIOC's oil operation in Iran had been nationalized contrary to the Concession Agreement between investor and host State. At issue was not so much whether the breach of the Concession Agreement amounted to a breach of international law. Rather, the problem of contract stabilization primarily resulted from defects in the dispute settlement and enforcement mechanisms for breaches of the Concession Agreement. On the investor-State level, the arbitration clause in the concession was ineffective, because it referred to an appointing authority that had ceased to exist.<sup>150</sup> On the inter-State level, a claim by the United Kingdom before the International Court of Justice (ICJ) failed because Iran had only accepted the Court's jurisdiction relating to breaches of treaties, not however with respect to customary law.<sup>151</sup> The enforcement problem as regards the investor-State contract therefore resulted not from a lack in substantive protection, but rather from insufficiencies in third-party dispute settlement mechanisms.

As a consequence, a primary concern in the settlement negotiations between AIOC and Iran were the protection of the to-be-concluded settlement arrangements against unilateral breaches by the State. Lauterpacht, as AIOC's advisor, therefore, suggested a double strategy: first, the inclusion of an internationalization clause in the final settlement agreement

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149. *Id.* at 414.

150. The Concession Agreement designated the President of the PCIJ as the appointing authority. After the end of the PCIJ, the President of the ICJ refused to regard himself as the successor of the President of the PCIJ and declined to serve as the appointing authority under the Concession Agreement. See D. H. N. Johnson, *The Constitution of an Arbitral Tribunal*, 30 BRIT. Y.B. OF INT'L L. 152 (1953); Elihu Lauterpacht, *International Law and Private Foreign Investment*, 4 IND. J. GLOBAL LEGAL STUD. 259, 271-72 (1997).

151. Anglo-Iranian Oil Co. (U.K. v. Iran), 1952 I.C.J. 93 (July) (Preliminary Objections).



that would subject the contractual obligations between the host State and the investor directly to international law, and second, the conclusion of an international treaty between the United Kingdom and Iran that would have mirrored the settlement agreement between the investor and the State. The effect of this construct was intended to be "that a breach of the contract or settlement shall be *ipso facto* deemed to be a breach of the treaty."<sup>152</sup> This arrangement would have offered a choice of forum for the parties involved: AIOC could have either had recourse to the arbitration mechanism under the investor-State settlement agreement or had the United Kingdom government pursue the claim as a breach of the umbrella treaty on an inter-State level.<sup>153</sup> In case of an inter-State dispute, it seemed clear that the ICJ would have had to decide whether a breach of the settlement agreement had occurred and directly attach the consequences of State responsibility to a breach of the contract.

Clearly, the primary purpose of Lauterpacht's construction of the umbrella treaty was to provide contract stability by providing an enforcement mechanism for the contractual arrangements between the investor and the host State. The purpose was "to add an inter-state remedy for breach of the settlement agreement to a process of internationalization already underway in the choice of the governing law and the watertight arbitration clause contained in the Consortium Agreement [i.e. the settlement agreement]."<sup>154</sup> By contrast, the umbrella treaty as such would not have affected the governing law of the contract. It would have merely supplemented the contractual obligation with a parallel obligation between the State parties involved, without however at this point providing for a direct right of action of the investor in an international dispute settlement forum.

Lauterpacht's suggestion of an independent treaty-based protection of investor-State contracts soon made its way into draft conventions for the protection of foreign investment. The 1959 Abs-Shawcross Draft Convention on Investments Abroad contained a provision according to which "[e]ach Party shall at all times ensure the observance of any undertakings which it may have given in relation to investments made by nationals of

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152. Elihu Lauterpacht, *Anglo-Iranian Oil Company Ltd. Persian Settlement - Opinion*, Jan 20, 1954, p. 4 (as cited in Sinclair, *supra* note 2, at 415).

153. Sinclair, *supra* note 2, at 416.

154. *Id.*

any other Party.”<sup>155</sup> With its provisions on inter-State and investor-State dispute settlement,<sup>156</sup> the primary effect of this provision was to enable effective enforcement of investor-State contracts. The provision was, however, not intended to change the governing law of covered investor-State contracts, but merely to stabilize them procedurally against *ex post* breaches.

The same holds true for other umbrella clauses that were inspired by the Abs-Shawcross Draft and included in other draft conventions and BITs in the late 1950s and 1960s.<sup>157</sup> The 1967 OECD Draft Convention on the Protection of Foreign Property, for example, provided in Art. 2 that “[e]ach Party shall at all times ensure the observance of undertakings given by it in relation to property of nationals of any other Party.”<sup>158</sup> Like the earlier Abs-Shawcross Draft, this provision aimed at providing an international law remedy for the enforcement of host State promises. By contrast, as explained in a committee report by the American Bar Association,

[i]t would not turn private contracts into treaties; it would not create obligations where none arose under the applicable law; it would not impair sovereignty or the police power; but it would provide for giving effect in an international forum to acquired rights arising from State contracts, and in this way it would ensure the application of an international standard where under international law that standard should be applied.<sup>159</sup>

What the historic development of umbrellas clause suggests is that the clauses focused primarily on providing procedural remedies for breaches of host State promises, in particular investor-State contracts, in order to make such bargains enforceable. Historically, umbrella clauses were a reaction to the insufficient protection of investor-State contracts and quasi-

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155. Draft Convention on Investments Abroad art. 2, *The Proposed Convention to Protect Private Foreign Investment: A Round Table*, 1 JOURNAL OF PUB. LAW 115–18 (1960), reprinted in UNCTAD, 5 INTERNATIONAL INVESTMENT INSTRUMENTS: A COMPENDIUM, 395 (2000) [hereinafter *Abs-Shawcross Draft*]. The draft was a combined and revised instrument of two earlier proposals made separately by Abs and Shawcross; for more information on this and a discussion of the earlier separate drafts, see Sinclair, *supra* note 2, at 418; Ignaz Seidl-Hohenveldern, *The Abs-Shawcross Draft Convention to Protect Private Foreign Investment: Comments on the Round Table*, 10 J. PUB. L. 100 (1961).

156. Abs-Shawcross Draft, *supra* note 155, art. 7.

157. See Sinclair, *supra* note 2, at 427 (making reference, *inter alia*, to similar clauses that were subsequently introduced into the investment treaties of Germany, France, the United States, and the United Kingdom).

158. OECD, Draft Convention on the Protection of Foreign Property, Publication No. 23081, Nov. 1967, reprinted in 7 I.L.M. 117, 123 (1968).

159. ABA, THE PROTECTION OF PRIVATE PROPERTY INVESTED ABROAD, 96 (1963).

contractual arrangements under national and international law and aimed at remedying the lack of effective dispute resolution mechanisms in investor-State contracting. They were designed and intended to remedy the blind spots that the dualist framework created by separating the contractual bond between host State and investor from contract protection under international law. As such, they were not intended as a purely declaratory clarification of customary international law to the effect that contractual rights could form the object of an expropriation, but intended to stabilize investor-State cooperation more comprehensively against any form of *ex post* opportunistic behavior of the host State by allowing for effective third-party dispute settlement.

The historic perspective, in other words, seamlessly fits in with understanding umbrella clauses as breaking with the dualist framework of international law and providing an enforcement mechanism for host State promises, independent of whether breaches were of a sovereign or a commercial nature. The restrictive approach to the interpretation of umbrella clauses therefore disregards not only the importance of enforcement of host State promises for efficient investor-State cooperation, but also the historic evidence that general international law and the precursors of modern-day umbrella clauses have never understood the national/international law divide as a dogma that could not be surmounted by treaty provisions that either submitted contract claims to international dispute resolution or contained provisions that transformed the observance of such promises into a treaty obligation under international law.

#### IV. THE EFFECT OF UMBRELLA CLAUSES ON INVESTOR-STATE RELATIONS

The previous section argued that the function of umbrella clauses consists in providing a forum for settling disputes about breaches of investment-related promises by host States vis-à-vis foreign investors independent of whether such breaches arise from sovereign or commercial conduct of the State. A different issue is, however, the question of what effect, if any, umbrella clauses have on the content of the relationship between investor and host State. This concerns the influence of umbrella clauses on the substantive obligations of the parties to an investor-State contract and the relationship between investment treaty

arbitration and forum selection clauses included in an agreement between investor and State. Do umbrella clauses only open an additional forum for the settlement of contractual and quasi-contractual disputes between investors and host States, or do they also affect the content of the substantive obligations? Do they also stabilize the contractual relationship between investor and host State and immunize it against every change in the regulation of the contract? The latter is often suggested when describing umbrella clauses as endorsing the principle of *pacta sunt servanda*.

Yet, this section argues that umbrella clauses in investment treaties do not incorporate the sanctity of contracts as a principle that immunizes investor-State relations against any future changes in the governing law or the regulatory environment, or shield the contractual bond from all sorts of commercial risks. Instead, this section argues that the general function of umbrella clauses to protect investors against *opportunistic behavior* of host States translates into a more differentiated framework for the substantive function of umbrella clauses. Even though disputes about any breach of an investor-State contract can be submitted to investment treaty arbitration based on an umbrella clause, the umbrella clause does not have the effect of stabilizing the contractual bond against every conceivable risk. Instead, it only upholds the sanctity of contracts against opportunistic behavior of host States, but does not provide solutions to problems arising from gaps in investor-State contracts; nor does it exclude good faith regulation of contracts based on the police power of the State or the exercise of the State's prerogative of eminent domain in regard of contractual rights. In this respect, umbrella clauses are indeed merely codifications of customary international law. Concerning the relation between treaty-based arbitration and forum selection clauses, by contrast, this section supports the primacy of the consent of the host State to arbitration under the treaty.

#### A. UMBRELLA CLAUSES AND APPLICABLE LAW

The application of umbrella clauses gives rise to the question whether the clauses change the applicable law governing the relationship between the investor and the State and accordingly constitute choice of law clauses. In fact, some tribunals have based their unease concerning the application of umbrella clauses on the idea that the clauses would transform

contractual obligations governed by municipal law into treaty obligations governed by international law. The Tribunal in *SGS v. Pakistan*, for example, referred to the “transubstantiation of contract claims into BIT claims,”<sup>160</sup> suggesting that the contract was *ipso iure* transformed into an obligation under international law.<sup>161</sup> This view is also echoed in the connection drawn by various commentators between the umbrella clause and internationalization clauses that subject a contract between a State and a private individual to international law.<sup>162</sup>

However, umbrella clauses differ fundamentally from choice of law clauses and leave the applicable law that governs an investor-State contract unaffected. This difference becomes clear from the fact that umbrella clauses occasionally appear parallel to choice of law clauses in international investment treaties.<sup>163</sup> While umbrella clauses constitute a substantive obligation under an investment treaty, choice of law clauses determine the applicable law in an investor-State dispute. Choice of law or applicable law clauses would thus determine whether an umbrella clause as part of an international treaty applies as part of the governing law in a specific investor-State dispute. An

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160. *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, ICSID (W. Bank) Case No. ARB/01/13, Decision on Objections to Jurisdiction, para. 172 (Aug. 6, 2003).

161. The idea that the umbrella clause “transforms” investor-State contracts into international obligations also lurks behind Prosper Weil’s conceptualization of umbrella clauses. See Weil, *supra* note 3, at 130.

L'intervention du traité de couverture transforme les obligations contractuelles en obligations internationales et assure ainsi, comme on l'a dit, l'intagibilité du contrat sous peine de violer le traité; toute inexécution du contrat, serait-elle même régulière au regard du droit interne de l'Etat contractant, engage dès lors la responsabilité internationale de ce dernier envers l'Etat national du cocontractant.

*Id.* (footnote omitted). Cf. U.N. CONFERENCE ON TRADE & DEV., *supra* note 3, at 56 (suggesting that an umbrella clause “might possibly alter the legal regime and make the agreements subject to the rules of international law”).

162. See Wälde, “Umbrella Clause” in *Investment Arbitration*, *supra* note 4, at 205 (pointing out that a “treaty’s umbrella clause . . . partly replaces the need to negotiate in the contract with the host State an internationalization regime consisting of stabilization, arbitration and an international-law clause”). See also Weil, *supra* note 3, at 171 (observing that the umbrella clause leads to an internationalization of investor-State contracts because “elle reflète la volonté des Etats de hisser en quelque sorte ces contrats sur la scène internationale”).

163. See, e.g., Agreement Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Argentina for the Protection and Promotion of Investments, U.K.-Arg., Dec. 11, 1990, entry into force Feb. 9, 1993 (containing an umbrella clause in Art. 2(2) and a choice of law clause for investor-State disputes in Art. 8(4)).

umbrella clause by itself cannot therefore determine its application similar to a choice of law clause.

Assuming that umbrella clauses change the law governing the investor-State relationship also confuses the inter-State relationship, which contains the umbrella clause as part of an international investment treaty, with the investor-State relations. While the obligations in the BIT are obligations entered into under international law, the relations between investor and host State remain governed by whatever law the parties to the investor-State contract have chosen as the applicable law. Therefore umbrella clauses, as an inter-State obligation, do nothing more than engage the host State's international responsibility for breaches of its investment-related promises. In contrast, the content of the obligation and the question whether a breach has occurred is to be determined according to the law applicable to this promise. Umbrella clauses do nothing more than back up the contractual bargain struck between the parties and enable the investor to enforce the commitments accepted by the host State in the treaty-based forum. They do not, however, affect the content of the substantive obligations between investor and host State.

The interplay between contract law and treaty law is well illustrated in the decision in *SGS v. Philippines* where the Tribunal commented upon the relationship between the law applicable to the contract and the umbrella clause. It stated that an umbrella clause:

does not convert non-binding domestic blandishments into binding international obligations. It does not convert questions of contract law into questions of treaty law. In particular it does not change the proper law of the CISS Agreement from the law of the Philippines to international law. Article X(2) addresses not the scope of the commitments entered into with regard to specific investments but the performance of these obligations, once they are ascertained.<sup>164</sup>

Similarly, the Annulment Committee in *CMS v. Argentina* states that “[t]he effect of the umbrella clause is not to transform the obligation which is relied on into something else; the content of the obligation is unaffected, as is its proper law.”<sup>165</sup> Even though umbrella clauses break with the dualist

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164. *Société Générale de Surveillance S.A. v. Republic of the Philippines*, ICSID (W. Bank) Case No. ARB/02/6, Decision on Objections to Jurisdiction, para. 126 (Jan. 29, 2004) (internal citation omitted).

165. *CMS Gas Transmission Co. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/01/8, Decision on Annulment, para. 95(c) (Sept. 25, 2007).

conception of international law when it comes to the clauses' enforcement function, it is thus crucial to distinguish clearly between the law governing the substance of the relations on the inter-State and the investor-State level.<sup>166</sup>

In the terminology of conflicts of laws, the questions of whether a commitment of the host State exists and whether this commitment has been breached are preliminary questions that have to be answered positively before examining whether an umbrella clause under an investment treaty has been breached. The content of the host State's commitments vis-à-vis a foreign investor and the question of whether such commitments have been breached have to be determined according to the law governing the investor-State relations. This encompasses questions of contract formation, contract validity, contract interpretation, and the influence of factual developments taking place after the conclusion of the contract, such as impossibility of performance, frustration of purpose, etc. All these questions are governed by the law applicable to the investor-State relations. For example, if an investor-State contract is governed by Philippine law, it is Philippine law that determines how gaps in a contract are to be filled and which legal instruments are applicable in this regard. It is, by contrast, not a question that is answered by the umbrella clause under the investment treaty, which only governs the inter-State relations. Thus, umbrella clauses only engage the host State's international responsibility once a breach of the law governing the investor-State relations has occurred. The competence to determine whether this is the case rests with the treaty-based forum seized.<sup>167</sup>

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166. See Mayer, *supra* note 19, at 37 ("Cette position [i.e., that of Prosper Weil] méconnaît qu'il existe deux rapports distincts et parallèles: le rapport *inter partes*, entre parties au contrat d'Etat, qui reste soumis à la *lex contractus*, et le rapport interétatique, qui relève du droit des gens. Que la violation par l'Etat de ses obligations nées du contrat constitue en même temps la violation du traité ne suffit pas à altérer la nature de l'un ou de l'autre.")

167. The application and construction of domestic law has played a role in a number of international cases. See, e.g., Questions relating to Settlers of German Origin in Poland, Advisory Opinion, 1923 P.C.I.J. (ser. B) No. 6, at 29 (Sep. 10); German Interests in Polish Upper Silesia (F.R.G. v. Pol.), 1926 P.C.I.J. (ser. A No. 7, at 19 (May 25) ("From the standpoint of International Law and of the Court which is its organ, municipal laws are merely facts which express the will and constitute the activities of States, in the same manner as do legal decisions or administrative measures."); *Mavrommatis Jerusalem Concessions (Greece v. U.K.)*, 1925 P.C.I.J. (ser. A) No. 2, at 29-33 (Mar. 26) (concerning the question of validity of a concession governed by national law); *Serbian Loans*, *supra* note 49, at 15-19 (discussing interpretation of bonds governed by national law).

## B. UMBRELLA CLAUSES AND FORUM SELECTION CLAUSES

Another question concerning the interplay between international law and the law governing the relations between the State and the foreign investor concerns the contentious question of whether an investor can initiate investment treaty arbitration based on the violation of an umbrella clause despite the existence of the forum selection clause in the investor-State contract in favor of the courts of the host State or arbitration. *Prima facie*, two solutions seem possible. The contractual forum selection could exclude investment treaty arbitration based on the argument that this is the forum the parties to the contract envisaged as the competent forum to decide on claims for the breach of contract. As long as host State and investor abide by this choice, one could argue, no violation of the contractual framework that was chosen as the governing framework for the investor-State relations has occurred. Alternatively, one could accord primacy to the treaty-based forum to resolve contractual disputes between the investor and the host State as violations of the umbrella clause and emphasize the separability between the substantive obligations that govern the content of investor-State relations and the forum selection as an agreement relating to enforcement and dispute settlement.

In arbitral practice, however, the conflict between contractual forum selection and treaty-based arbitration in the context of umbrella clauses has received different solutions. Some tribunals and commentators argue that the jurisdiction of treaty-based tribunals trumps any contrary forum selection for claims for the violation of the treaty. The opposing approach considers that forum selection clauses should take precedence over treaty-based dispute settlement concerning the violation of an umbrella clause. The Tribunal in *SGS v. Pakistan*, for example, considered that a broad understanding of umbrella clauses would enable an investor to “render any mutually agreed procedure of dispute settlement, other than BIT-specified ICSID arbitration, a dead-letter, at the investor’s choice. The investor would remain free to go to arbitration either under the contract or under the BIT.”<sup>168</sup> Similarly, the majority in *SGS v. Philippines* accorded primacy to the forum selection clause in the case at hand in alluding to “[t]he basic principle . . . that a

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168. *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, ICSID (W. Bank) Case No. ARB/01/13, Decision on Objections to Jurisdiction, para. 168 (Aug. 6, 2003); see also *Eureko*, *supra* note 6, para. 11 (Rajski, dissenting).



binding exclusive jurisdiction clause in a contract should be respected, unless overridden by another valid provision.”<sup>169</sup> It considered that “the BIT did not purport to override the exclusive jurisdiction clause in the [investor-State contract], or to give SGS an alternative route for the resolution of contractual claims which it was bound to submit to the Philippine courts under that Agreement.”<sup>170</sup> As a consequence, the Tribunal in *SGS v. Philippines* decided to stay the treaty-based proceedings in view of the proceedings that were already pending in Philippine courts. It thus gave effect to the premise that a breach of the umbrella clause would require that a breach of the underlying investor-State contract was not remedied in accordance with the dispute settlement mechanism the parties chose.

The majority of tribunals, by contrast, take the opposite approach and view, like the dissenting opinion in *SGS v. Philippines*, the host State’s consent to arbitration under the BIT as a forum that can be seized alternatively to any contractually selected forum.<sup>171</sup> In *Eureko v. Poland*, for example, the Tribunal accepted its jurisdiction based on an umbrella clause for a dispute about the breach of an investor-State agreement relating to the privatization of a State-owned insurance company, although the agreement contained a forum selection clause in favor of Polish courts. The Tribunal reasoned that since the violation of an umbrella clause constituted a treaty-based cause of action, the contractual forum selection could not exclude treaty-based arbitration.<sup>172</sup> In its support, the Tribunal relied on the settled arbitral jurisprudence that contractual forum selection clauses could not derogate from the jurisdiction of treaty-based tribunals for claims based on the breach of treaty.<sup>173</sup> Unlike in *SGS v. Philippines*, the contractual

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169. *SGS v. Philippines*, ICSID Case No. ARB/02/6, at para. 138. See generally *id.* paras. 136–55.

170. *Id.* para. 143; see also *id.* para. 141 (explaining that a “framework treaty, intended by the States Parties to support and supplement, not to override or replace, the actually negotiated investment arrangements made between the investor and the host State”).

171. *Id.* paras. 4–5 (Crivellaro, dissenting).

172. *Eureko*, *supra* note 6, paras. 92–114, 250.

173. See *Bayindir Insaat Turizm Ticaret Ve Sanayi A.S. v. Islamic Republic of Pakistan*, ICSID (W. Bank) Case No. ARB/03/29, Decision on Jurisdiction, paras. 264–73 (Nov. 14, 2005); *Impregilo S.p.A. v. Islamic Republic of Pakistan*, ICSID (W. Bank) Case No. ARB/02/17, Decision on Jurisdiction, para. 286–90 (Apr. 22, 2005); *SGS v. Pakistan*, ICSID Case No. ARB/01/13, at para. 161; *Compañía de Aguas del Aconquija, S.A. and Vivendi Universal v. Argentine Republic*, ICSID (W. Bank) Case

forum in the case at hand had not been seized prior to investment arbitration. Furthermore, in *Noble Ventures v. Romania*, the Tribunal accepted, despite the existence of a forum selection clause, jurisdiction over the alleged breach of the terms of a privatization agreement for a State-owned steel mill that was concluded between the foreign investor and a State instrumentality.<sup>174</sup> In addition, a number of further decisions discarded the objection to the tribunals' jurisdiction based on the primacy of a forum selection clause between the foreign investor and the host State in cases where a violation of an umbrella clause was invoked.<sup>175</sup> These tribunals therefore assumed that treaty-based arbitration took primacy over a forum selection clause in case the violation of an umbrella clause was alleged.

Several arguments, however, support the view that a contractual forum selection clause cannot override the consent to arbitration under a BIT when the investor invokes a violation of the umbrella clause and therefore brings a claim based on the international responsibility of the host State for the breach of its promise. First, a violation of an umbrella clause has to be qualified as a violation of an inter-State obligation. Consequently, its cause of action is based on an international treaty, not on the breach of an investor-State contract. It constitutes a treaty claim, not a contract claim. Accordingly, the firmly established jurisprudence that contractual forum

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No. ARB/97/3, Decision on Annulment, paras. 75 (July 3, 2002); *Compañía de Aguas del Aconquija, S.A. & Compagnie Générale des Eau v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/97/3, Award, paras. 53–55 (Nov. 21, 2000); *Lanco Int'l Inc. v. Argentina*, ICSID (W. Bank) Case No. ARB/97/6, Decision on Jurisdiction paras. 21–28 (Dec. 8, 1998). The dissenting opinion in *Eureko v. Poland*, by contrast, took the contrary position and criticized the majority's solution, noting that "by opening a wide door to foreign parties to commercial contracts concluded with a State-owned company to switch their contractual disputes from normal jurisdiction of international commercial arbitration tribunals or state courts to BIT Tribunals." *Eureko*, *supra* note 6, para. 11 (Rajski, dissenting).

174. *Noble Ventures, Inc. v. Romania*, ICSID (W. Bank) Case No. ARB/01/11, Award, para. 2 (Oct. 12, 2005).

175. See *Camuzzi Int'l S.A. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/03/7, Decision on Jurisdiction, paras. 105–19. (June 10, 2005); *AES Corp. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/02/17, Decision on Jurisdiction, paras. 90–99 (May 26, 2005); *Enron Corp. and Ponderosa Assets L.P. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/01/13, Decision on Jurisdiction, para. 89–94 (Jan. 14, 2004); *Azurix Corp. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/01/12, Decision on Jurisdiction, paras. 75–81 (Dec. 8, 2003); *CMS Gas Transmission Co. v. Republic of Argentina*, ICSID (W. Bank) Case No. ARB/01/8, Decision on Objections to Jurisdiction, paras. 70–76 (July 17, 2003).

selection clauses cannot override the consent to investor-State arbitration relating to the violations of an investment treaty also has to apply to a claim involving the violation of an umbrella clause. The same rationale applies to violations of umbrella clauses as to breaches of other provisions of investment treaties, namely that the subject matters and the causes of action of contract claims and treaty claims differ.<sup>176</sup> While the contract claim concerns the liability of the host State vis-à-vis the foreign investors under the law applicable to the investor-State contract, the treaty claim under the umbrella clause relates to the international responsibility of the host State for the violation of an obligation vis-à-vis the investor's home State. That the parties to the investment dispute are the same as the parties to a contractual claim under the selected forum is, however, irrelevant as investment treaty arbitration "is not only a specific dispute settlement mechanism between foreign investors and host States, but also a compliance mechanism for the inter-State obligations contained in the substantive provisions of the international investment treaty."<sup>177</sup> In this view, the investor does not only bring a claim in its own name for enforcing its right under an investor-State contract, but also enforces the umbrella clause obligation under the investment treaty in place between the host State and the investor's home State.<sup>178</sup>

That a contractual forum selection clause cannot bind a treaty-based tribunal sitting on the question of a violation of the umbrella clause as an obligation under international law also becomes clear, if one envisages the case that the investor's home State decides to initiate inter-State arbitration under a BIT and invokes the violation of the treaty's umbrella clause. In this

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176. Bernardo Cremades & David J. A. Cairns, *Contract and Treaty Claims and Choice of Forum in Foreign Investment Disputes*, in *ARBITRATING FOREIGN INVESTMENT DISPUTES*, *supra* note 89, at 325, 327–32 (explaining that contract rights and treaty rights differ concerning the source of the right, the content of the right, the parties to the claim, the applicable law, and the liability of the host State once as a matter of domestic law, once based on its international responsibility).

177. Schill, *supra* note 120, at 681.

178. *See id.*, at 681–83; *see also* Loewen Group, Inc. and Raymond L. Loewen v. United States of America, ICSID Case No. ARB(AF)/98/3, Award, para. 233 (June 26, 2003) ("claimants are permitted for convenience to enforce what are in origin the rights of Party states"). *Cf.* SGS Société Générale de Surveillance S.A. v. Republic of the Philippines, ICSID (W. Bank) Case No. ARB/02/6, Decision on Objections to Jurisdiction, para. 154 (Jan. 29, 2004) ("Although under modern international law, treaties may confer rights, substantive and procedural, on individuals, they will normally do so in order to achieve some public interest.") (internal citation omitted).

case, the State would clearly not be bound by the contractual forum selection in the investor-State relation, because the investor does not dispose of the power to restrict its home State concerning the arbitration mechanism under an international treaty. In addition, the dispute settlement mechanism under a BIT cannot be overridden or dispensed with under a forum selection clause, because this would effectively contain a prospective waiver of the right offered to a foreign investor in an international treaty to have recourse to a treaty-based tribunal.<sup>179</sup> If one perceives investment treaty arbitration as private enforcement of public international law, there is no reason why the investor should be treated less favorably than its home State in terms of access to arbitration under the treaty-based forum.

Furthermore, the view that the investor-State obligation under the umbrella clause has only been breached after the contractual forum has been seized can be countered by the concept of the severability of the contract's arbitration clause and the substantive obligations stipulated in the treaty. The concept of severability views contractual arbitration clauses as an agreement between the parties that is independent from the substantive obligations. This concept is not only uniformly accepted in commercial arbitration,<sup>180</sup> but also in various cases under international law.<sup>181</sup> Similarly, Art. 25 of the ICSID Convention supports the independence of the consent to arbitration from the underlying substantive obligations between

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178. On the question of whether an investor can waive the rights granted under an international investment treaty, see Schöbener & Markert, *supra* note 114, at 96 *et seq.* (declining this possibility because the investor does not have the power to dispose over rights and obligations under international law and would thus violate interests his home State may have in enforcing the substantive obligations under the BIT). See also Wälde, "Umbrella Clause" in *Investment Arbitrations*, *supra* note 4, at 211, 232 (with further references). But see Ole Spiermann, *Individual Rights, State Interests and the Power to Waive ICSID Jurisdiction*, 20 *ARB. INT'L* 179, 210 (2004).

180. See, e.g., GARY B. BORN, *INTERNATIONAL COMMERCIAL ARBITRATION: COMMENTARY AND MATERIALS* 55-74 (2d ed. 2001) (with further references).

181. See *Plama Consortium Ltd. v Bulgaria*, ICSID Case No. ARB/03/24, Decision on Jurisdiction, para. 212 (Feb. 8, 2005); *Stran Greek Refineries and Stratis Andreadis v. Greece*, Judgment of Dec. 9, 1994, Ser. A - 301-B, 65, para. 72; *Texaco Overseas Petroleum Company and California Asiatic Oil Company v. Government of the Arab Republic of Libya*, 1975, 53 *I.L.R.* 389, 393 (R.J. Dupuy, Sole Arb. 1979) (Preliminary Decision of Nov. 27); *The Losinger & Co. Case*, Decision of Oct. 11, 1935, P.C.I.J. Reports (Ser. C) No. 78, p. 110; *Lena Goldfields Company Ltd v. Soviet Government*, 5. *Ann. Dig. & Rep. Pub. Int'l L. Cases* (1929-1930) (case no. 258).

the parties.<sup>182</sup> Accordingly, the violation of the substantive rights and obligations contained in an investor-State contract can be severed from the contractual forum selection clause.

Finally, reasons of efficiency and expediency militate for the overriding effect of BIT arbitration. Uniting all claims for the violation of a BIT, including those contractual breaches brought under an umbrella clause, supports the effective dispute settlement in a single forum and promotes the efficient solution of disputes.<sup>183</sup> These concerns are not outweighed by the argument, often invoked in favor of requiring parties to first seize the contractually chosen forum, that the chosen forum, in particular domestic courts, would be better placed to decide disputes relating to the interpretation and application of the substantive law that governs the investor-State relations. The argument purports that domestic courts, or any other contractually chosen forum, would be better placed to decide contractual questions in the context of an umbrella clause violation, because domestic judges have superior knowledge of the governing law compared to arbitrators sitting at the international level. Although this argument has some intuitive appeal, it does not take into account that often investor-State contracts do not primarily turn on intricate questions concerning the interpretation and application of domestic law, but are primarily difficult with respect to often comprehensive factual issues. But even if it were true that intricate questions of domestic law are decisive for a certain dispute, host State and investor would be free to appoint arbitrators for resolving their dispute in a unitary treaty-based forum that bring the requisite expertise to the table. Apart from that, one of the reasons why international arbitration has developed as a mechanism to stabilize investor-State cooperation and enforce promises the host State has given is precisely the insufficiencies that exist in domestic dispute settlement.<sup>184</sup> Referring parties to a contractually chosen forum may thus frustrate the very basis and justification of investment treaty arbitration and the

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182. See Weil, *supra* note 3, at 223.

183. Cf. Christoph Schreuer, *Calvo's Grandchildren: The Return of Local Remedies in Investment Arbitration*, 4 *The Law & Practice of Int'l Courts and Tribunals* 1, 12 (2005) ("If competing competences exist, it makes more sense to have the entire dispute heard by one forum, preferably the one with the most comprehensive jurisdiction. If the terms of reference in the BIT are broad enough to include contract claims in addition to treaty claims the international tribunal would be the one with the broadest jurisdiction.")

184. See *supra* Part II.B.1.

creation of umbrella clauses as a mechanism that remedies insufficiencies in the enforcement of contractual promises of the host State vis-à-vis foreign investors.

Certainly, understanding the jurisdictional function of umbrella clauses in such a broad fashion creates certain problems of competing jurisdiction and enables forum shopping by foreign investors who could potentially seize the contractual forum in a first step and subsequently invoke the violation of the umbrella clause in an investment treaty in case the first proceedings did not yield the desired result. However, in order to deny the investor a second bite at the apple, such situations can arguably be dealt with efficiently by concepts such as *abus de droit*, *res judicata*, or estoppel.<sup>185</sup> Likewise, judicial comity or a broad understanding of *lis pendens* might constitute ways to avoid parallel and/or subsequent proceedings.<sup>186</sup> On this basis, one can also justify the decision of the majority in *SGS v. Philippines* to stay the BIT proceedings in order to have the Philippine Court decide the dispute already submitted by the investor in accordance with the contractual forum selection and square it with the contrary approach in *Eureko v. Poland*, where the investor had not initiated proceedings in conformity with the forum selection clause.

As a matter of principle, however, the decisions to stay investment treaty arbitration in order to allow the forum chosen by the parties to decide questions of contract interpretation and breach, seems unconvincing not only in terms of the multiplication of proceedings and the efficiency and expediency of dispute resolution. It also is incompatible with the classification of claims for the violation of umbrella clauses as treaty claims. Accordingly, claims for the violation of umbrella clauses should not be treated differently from claims for the violation of other investment treaty provisions, such as fair and equitable treatment or the concept of indirect expropriation.

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185. See Yuval Shany, *Contract Claims vs. Treaty Claims: Mapping Conflicts between ICSID Decisions on Multisourced Investment Cases*, 99 AM. J. INT'L L. 835, 849–51 (2005). Concepts of *lis pendens* or *res judicata*, by contrast, will not be operative, because of the different nature of the contract claim and the claim for the violation of the umbrella clause, even though the content of the host State's obligation is identical. *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, ICSID (W. Bank) Case No. ARB/01/13, Decision on Objections to Jurisdiction, para. 182 (Aug. 6, 2003). For the arguments of the parties on this point, see *id.* paras. 46, 52, 60–61, 111–17. Cf. Christer Söderlund, *Lis Pendens, Res Judicata and the Issue of Parallel Judicial Proceedings*, 22 J. INT'L ARB. 301 (2005).

186. Shany, *supra* note 185, at 849–50.

With respect to those treaty claims, the Tribunals in *Impregilo v. Pakistan*<sup>187</sup> and *Bayindir v. Pakistan*<sup>188</sup> declined to stay ICSID arbitration in view of national court proceedings on the argument that the cause of action under the BIT was different from the cause of action for breach of treaty. Even though neither case alleged the breach of an umbrella clause, the observation of the Tribunal in *Bayindir v. Pakistan*, should be applied to any treaty claim including claims for the violation of an umbrella clause:

When the investor has a right under both the contract and the treaty, it has a self-standing right to pursue the remedy accorded by the treaty. The very fact that the amount claimed under the treaty is the same as the amount that could be claimed (or was claimed) under the contract does not affect such self-standing right.<sup>189</sup>

### C. OPPORTUNISTIC HOST STATE BEHAVIOR VERSUS CONTINGENCIES

If investor-State contracts were in fact complete contracts, i.e. contracts that govern the mutual rights and obligations without *lacunae*, umbrella clauses would allow investors to enforce their contractual rights *tels quels*. Yet contracts, especially complex contracts in long-term relationships, are never complete.<sup>190</sup> They contain gaps and do not cover every possible aspect of the parties' relation, because the future state of the world is not fully predictable and the costs for negotiating and drafting complete contracts are prohibitively high. As a consequence, not all aspects that are or might become relevant for the parties' relationship can be included from an *ex ante* perspective at the time of contract formation. Regularly, the stability of the parties' contractual bond, therefore, needs to be complemented by *ex post* dispute settlement and enforcement mechanisms in order to effectively counter incentives for either party to behave opportunistically.

Yet, the stability of long-term contracts does not only have

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187. *Impregilo S.p.A. v. Islamic Republic of Pakistan*, ICSID (W. Bank) Case No. ARB/02/17, Decision on Jurisdiction, paras. 286–90 (Apr. 22, 2005).

188. *Bayindir Insaat Turizm Ticaret Ve Sanayi A.S. v. Islamic Republic of Pakistan*, ICSID (W. Bank) Case No. ARB/03/29, Decision on Jurisdiction, paras. 264–73 (Nov. 14, 2005).

189. *Id.* at para. 167.

190. See Lewis A. Kornhauser, *An Introduction to the Economic Analysis of Contract Remedies*, 57 U. COLO. L. REV. 683, 691–92 (1986); see also Pierpaolo Battigalli & Giovanni Maggi, *Rigidity, Discretion, and the Costs of Writing Contracts*, 92 AM. ECON. REV. 798 (2002)

to grapple with the contracting parties' opportunistic behavior to benefit from subsequent defects from contractual obligations. Long-term contracts are also confronted with the occurrence of unforeseen contingencies.<sup>191</sup> Contingencies are fundamentally different from opportunistic behavior. While the latter consists in rent-seeking behavior contrary to the risk allocation of the contract, the former is plainly outside the scope of the obligations assumed by the parties. The occurrence of contingencies is therefore an exogenous factor that, although it may offset the contractual bargain, does not result from opportunistic actions of one of the parties. Even though contract drafting techniques exist that aim at addressing the effect of future contingencies, such as renegotiation clauses,<sup>192</sup> the occurrence of contingencies can never be excluded completely due to the expenses connected to drafting a complete contract.<sup>193</sup>

While umbrella clauses clearly target opportunistic behavior of host States, they do not, it is submitted, prevent the intervention of the host State in adapting an investor-State contract in light of contingencies, or its refusal to perform based on contingencies. Such conduct does therefore not constitute a violation of an umbrella clause. Even though umbrella clauses are worded without hinting at the possibility of recognizing exceptions to the sanctity of contracts in case of contingencies, such an exception has to be implied. This can be based on a number of arguments. Apart from the fundamental difference between opportunistic rent-seeking behavior and contingencies that are outside the risk allocation of the contract in question, the acceptance of contingencies as excusing contractual performance has been accepted with respect to the predecessors of present-day umbrella clauses and is accepted as a general principle of law in a number of domestic legal system and general international law.

With respect to the umbrella clauses in the Abs-Shawcross Draft and the OECD Draft Convention, commentators opined that these provisions implicitly accepted exceptions to the

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191. On the difference between opportunism and contingencies, see RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 93 *et seq.* (6th ed. 2003).

191. Stefan Kröll, *The Renegotiation and Adaptation of Investment Contracts*, in *ARBITRATING FOREIGN INVESTMENT DISPUTES*, *supra* note 89, at 425; Klaus Peter Berger, *Äquivalenzstörungen, Neuerhandlungsklauseln und Vertragsanpassung bei internationalen Konzessionsverträgen sowie Probleme der Streitschlichtung*, in *RECHTSPROBLEME VON AUSLANDSINVESTITIONEN* 65 (Jürgen F. Baur & Stephan Hobe eds., 2003).

193. See sources cited *supra* note 190.



sanctity of contracts. Shawcross himself acknowledged that Art. II of the Abs-Shawcross Draft did not intend to exclude the concept of the *clausula rebus sic stantibus* as part of customary international law, even though this did not appear in the clause's wording.<sup>194</sup> Similarly, the discussion about the effect of Art. 2 of the 1967 OECD Draft Convention on the Protection of Foreign Property suggests that this provision was subject to implicit exceptions for contingencies. A Committee Report of the American Bar Association, for example, concluded that the umbrella clause in the OECD Draft Convention "would not impair sovereignty or the police power; but it would provide for giving effect in an international forum to acquired rights arising from State contracts, and in this way it would ensure the application of an international standard."<sup>195</sup> Similarly, Seidl-Hohenveldern considered that the OECD Draft Convention, including its umbrella clause, "like any other treaty—would be subject to the *clausula rebus sic stantibus*"<sup>196</sup> and consequently allow for "a degree of flexibility."<sup>197</sup> In his view, the clause would thus not operate as a permanent freeze of the contractual arrangements in investor-State relations. This underscores that the limitation of the umbrella clause in targeting opportunistic behavior of host States was already well understood as an underlying concept of its interpretation and application in the 1960s.

The difference between preventing opportunistic behavior and the need to react flexibly to an unexpected change of circumstances can also be traced as a fundamental difference in virtually any domestic legal system. It is addressed by various concepts, including the doctrines of *clausula rebus sic stantibus*, *force majeure*, impossibility, frustration,<sup>198</sup> *imprévision*,<sup>199</sup> or the

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194. Hartley W. Shawcross, *The Problems of Foreign Investment in International Law*, 102 RECUEIL DES COURS 335, 353–55 (1961-I).

195. See ABA, *supra* note 159159, at 95 *et seq.*

196. Seidl-Hohenveldern, *supra* note 155, at 106.

197. *Id.*

198. See Stefan Schmiedlin, FRUSTRATION OF CONTRACT UND CLAUSULA REBUS SIC STANTIBUS, at 21–88 (Schriftenreihe des Instituts für Internationales Recht und Internationale Beziehungen [Series of publications of the Institute for International Law & International Relations] No. 38, 1985). See U.C.C. § 2-615 (2003) for the American codification of the concept of commercial impracticality; and on this, see generally Thomas R. Hurst, *Freedom of Contract in an Unstable Economy: Judicial Reallocation of Contractual Risks Under UCC Section 2-615*, 54 N.C. L. REV. 545 (1975).

199. See *Compagnie Générale d'Éclairage de Bordeaux*, CE, Mar. 30, 1916 in LES GRANDS ARRETS DE LA JURISPRUDENCE ADMINISTRATIVE 129–30 (M. Long, et al.

*Lehre von der Geschäftsgrundlage*,<sup>200</sup> and accepted in numerous domestic legal systems.<sup>201</sup> Furthermore, various projects of codification of principles of contract law<sup>202</sup> and international private law,<sup>203</sup> as well as numerous international arbitration awards, draw a distinction between opportunistic behavior and contingencies and accept that under certain circumstances unforeseen contingencies allow a departure from contractual obligations.<sup>204</sup> The distinction also features in the doctrine of change of circumstances under the Vienna Convention on the Law of Treaties.<sup>205</sup> Likewise, under customary international law,

eds., 8th ed. 2003); Compagnie des tramways de Cherbourg, CE Ass., Dec. 9, 1932 D. 1943 in C. CIV. art. 1134, para. 14 (Dalloz 101st ed. 2002).

199. See, e.g., Günter H. Roth, in *Münchener Kommentar zum Bürgerlichen Gesetzbuch*, vol. II, Art. 242 para. 594 (4th ed. 2001). The doctrine has been established as a special application of the principle of good faith and has been recently codified in Bürgerliches Gesetzbuch [BGB] [German Civil Code] PROMULGATION GAZETTE, § 313. The *Lehre von der Geschäftsgrundlage* also applies to public law contracts and is codified at Verwaltungsverfahrensgesetz [VwVfG] [German Administrative Law Code] § 60. The elements and consequences are essentially the same as under the general civil law. See Dieter Lorenz, *Der Wegfall der Geschäftsgrundlage beim verwaltungsrechtlichen Vertrag*, 112 DEUTSCHES VERWALTUNGSBLATT [DVBl.] 865 (1997).

201. See Schmiedlin, *supra* note 198, at 89–178 (concerning Swiss Law); PHONG-JIE SU, DIE KLAUSEL DER VERÄNDERTEN UMSTÄNDE IM CHINESISCHEN RECHT: ZUR REZEPTION DEUTSCHEN PRIVATRECHTS IN CHINA (1981) (on Chinese law); see also Codice civile [C.C.] [Civil Code] art. 1467 (Italy); Astikos Kodikas [A.K.] [Civil Code] art. 388 (Greece); Burgerlijk Wetboek [BW] [Civil Code] art. 258 (Neth.); Código Civil [Civil Code] art. 437 (Port.); Grazhdanskii Kodeks [GK] [Civil Code] art. 451 (Russ.).

202. See Principles of European Contract Law, Commission on European Contract Law, 2000, art. 6:111; UNIDROIT Principles of International Commercial Contracts, International Institute for the Unification of Private Law, 2004, art. 5.2.2.

203. On the question of whether Art. 79 of the Convention on the International Sale of Goods allows taking account of a change of circumstances, see Dionysios P. Flambouras, *The Doctrines of Impossibility of Performance and Clausula Rebus Sic Stantibus in the 1980 Convention on Contracts for the International Sale of Goods and the Principles of European Contract Law – A Comparative Analysis*, 13 PACE INT'L L. REV. 261, 277–81 (2001). Cf. CISG Advisory Council Opinion No. 7, Exemption of Liability for Damages under Article 79 of the CISG, paras. 26–40 (Oct. 12, 2007), available at <http://cisgw3.law.pace.edu/cisg/CISG-AC-op7.html#1>.

203. Manufacturing Plant (Neth. v. Turk.), ICC Award No. 8486, 24a Yb. Comm. Arb. 162, 167 (1999); Steel Bars (Egypt v. Yugo.), ICC Award No. 6281 15 Yb. Comm. Arb. 96, 98 (1990); Bank Guarantees (Ind. v. Pak.), ICC Award No. 1512, 1 Yb. Comm. Arb. 128, 129 (1976). See also Hans van Houtte, *Changed Circumstances and Pacta Sunt Servanda*, in TRANSNATIONAL RULES IN INTERNATIONAL COMMERCIAL ARBITRATION 105, 107 (Emmanuel Gaillard ed., 1993); RAINER VELTEN, DIE ANWENDUNG DES VÖLKERRECHTS AUF STATE CONTRACTS IN DER INTERNATIONALEN SCHIEDSGERICHTSBARKEIT 116 *et seq.* (1987).

204. Article 62 of the Vienna Convention on the Law of Treaties, *opened for*

the doctrine of change of circumstances has been read into contracts between States and foreign nationals.<sup>206</sup> This widespread acceptance of the doctrine in domestic and international law therefore suggests that it constitutes a general principle of law.<sup>207</sup>

What is common to all these doctrines is that they constitute ways of dealing with contingencies that arise in long-term relational contracts. The elements common to all expressions of the *clausula* in its various shades that justify an adaptation of the contractual relationship are:

- 1.the change of circumstances that were either explicitly stipulated or presupposed by the parties after the conclusion of the contract;
- 2.the risk of the change of circumstances is outside the sphere of risk of both parties according to the risk allocation of the contract;
- 3.the change of circumstances was not foreseeable; and
- 4.the change affected the contractual equilibrium significantly so that one has to assume that the parties would not have concluded the contract the way it has been concluded.

In sum, it is widely accepted both in domestic as well as in international law that the principle of *pacta sunt servanda* is not strictly adhered to but limited with respect to influence of future contingencies on the contractual bond. This widespread acceptance should thus also be mirrored in the interpretation and application of the umbrella clause in backing up private

*signature* May 23, 1969, 1155 U.N.T.S. 331, accepts the doctrine of change of circumstances for international treaties; see IAN BROWNLIE PRINCIPLES OF PUBLIC INTERNATIONAL LAW (4th ed. 1990) 619–21; Detlev F. Vagts, *Rebus Revisited: Changed Circumstances in Treaty Law*, 43 COLUM. J. TRANSNAT'L L. 459 (2005).

205. See ULRICH AMMANN, *DER SCHUTZ AUSLÄNDISCHER PRIVATINVESTITIONEN IN ENTWICKLUNGSLÄNDERN AUS VÖLKERRECHTLICHER, VOLKSWIRTSCHAFTLICHER UND BETRIEBSWIRTSCHAFTLICHER SICHT* 110–13. (1967); HELMUT FRICK, *BILATERALER INVESTITIONSSCHUTZ IN ENTWICKLUNGSLÄNDERN* 52 (1975). See also *LIAMCO v. Libya*, 20 I.L.M. 1, 57 (1981) (“[T]he binding force is subject to the continuance of circumstances under which a treaty was concluded. If such circumstances change substantially, then its modification or cancellation may be claimed or resorted to.”).

206. RALF KÖBLER, *DIE “CLAUSULA REBUS SIC STANTIBUS” ALS ALLGEMEINER RECHTSGRUNDSATZ* (1991); BIN CHENG, *GENERAL PRINCIPLES OF LAW* 113, 118–19 (1953) (stressing that a change in circumstances must have been not reasonably contemplated at the time of the conclusion of an international treaty); Norbert Horn, *Changes in Circumstances and the Revision of Contracts in Some European Laws and in International Law*, in *ADAPTATION AND RENEGOTIATION OF CONTRACTS IN INTERNATIONAL TRADE AND FINANCE* 15, 25 (Norbert Horn ed., 1985).

ordering between investors and host States. While opportunistic breaches of investor-State contracts clearly constitute a breach of the umbrella clauses, reactions to contingencies do not engage the international responsibility of the host State. However, in case the host State invokes a change of circumstances in order to change the terms of an investor-State contract or to deny performance of its obligations, specific attention has to be paid to the question of whether a specific circumstance is within or outside the allocation of risk provided for in the original bargain. The danger, of course, exists that the host State will use changes in circumstances as a pretext in order to extract additional benefits from the initial bargain and, thus act opportunistically. Consequently, an investment tribunal will have to apply strict scrutiny in order to delineate opportunistic behavior and the good faith reaction to contingencies. Notwithstanding, umbrella clauses do not exclude the invocation of doctrines addressing contingencies and consequently do not make host States liable for unforeseen future developments that are outside the contractual risk allocation.

#### D. REGULATION AND TERMINATION OF INVESTOR-STATE CONTRACTS

While doctrines relating to the change of circumstances concern the influence of future contingencies upon the relationship between the parties, another source of significant interference with the contractual rights under investor-State contracts is the host State's power to regulate or even terminate contracts in the public interest.<sup>208</sup> Both regulation and termination in the public interest can abridge the original promises made by the host State and thus negatively influence the contractual rights of an investor. Thus, the regulation of investor-State contracts—e.g. changing emission standards for a production plant run by a foreign investor—may impose additional burdens on the investor's economic activity, make the performance of its obligations more onerous, and thus affect the initial contractual equilibrium. The question, therefore, arises whether umbrella clauses prohibit such host State measures and immunize investor-State contracts against any regulation or termination in the public interest.

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208. Cf. COOTER & ULEN, *supra* note 35, at 185–87 (discussing the impact of government zoning regulation on private party relationships for development).

Unlike the unilateral reaction of the host State to contingencies, the regulation of contracts actually interferes with contractually negotiated rights and obligations. Contract regulation could thus be seen as a case of opportunistic behavior that constitutes a violation of an umbrella clause, since the host State avails itself of its sovereign power to modify or terminate the initial bargain. However, not every regulatory interference with contractual relationships constitutes opportunistic and rent-seeking behavior of the host State. Instead, certain regulatory conduct solely serves to further contract-external public interests. Such regulation, it is submitted, can be implemented without constituting a violation of an umbrella clause based on an implicit police power exception. Furthermore, in certain limited circumstances States can also terminate investor-State contracts based on a superseding public interest. Such an exception for the regulation of investor-State contracts can be justified, despite the lack of a basis in the wording of most umbrella clauses, with the host State's duty to act in the public interest that has always been recognized under customary international law and domestic legal systems and has arguably not been superseded by the conclusion of investment treaties. It is thus argued that a police power exception has to be read into the interpretation and application of umbrella clauses. Under this exception, the regulation of investor-State contracts and the interference with contractual rights in the public interest is permissible, provided that it does not impose disproportionate or discriminatory burdens on the foreign investor. In some cases this may require the payment of compensation in order to make the interference lawful. Yet, such interferences will not engage the host State's international responsibility for unlawful behavior based on a violation of an umbrella clause.

### *1. The State's Power to Interfere with Investor-State Contracts under Customary International Law*

State practice and jurisprudence of international courts and tribunals has rather consistently recognized that under customary international law States hold the power to interfere with investor-State contracts in the public interest and cannot contract away this power. Thus, in the *Oliva Case* the Italian-Venezuelan Claims Commission considered that the termination of a concession and the expulsion of the investor were justified

in the public interest, because the investor was suspected to have cooperated with revolutionary factions. However, the Commission required compensation of the investor because "a nation, like an individual, is bound by its contract and although it may possess the power to break it, is obliged to pay the damages resultant upon its action."<sup>209</sup> Similarly, the French-Venezuelan Claims Commission in *Company General of the Orinoco Case* accepted the entitlement of the host State to unilaterally terminate a mining concession that had created political tensions with a neighboring State. According to the Commission, as the government's "duty of self-preservation rose superior to any question of contract, it had the power to abrogate the contract in whole or in part . . . . It considered the peril superior to the obligation and substituted therefore the duty of compensation."<sup>210</sup>

Similarly, the Tribunal in *Czechoslovakia v. Radio Corporation of America* confirmed that "any alteration or cancellation of an agreement . . . as a rule should only be possible subject to compensation to the other party."<sup>211</sup> Notably, this case did not only refer to the cancellation of an investor-State contract but a modification of the content of a contract. Furthermore, the Tribunal emphasized that States could not restrict their obligation to regulate and interfere with investor-State contracts in the public interest by means of a contract with private individuals, but were restricted to make use of this power, subject to the requirement of compensation, in order to protect "public interests of vital importance."<sup>212</sup> Similarly, several other arbitral decisions recognized the entitlement of the State to terminate public contracts subject to paying compensation to affected foreign investors.<sup>213</sup>

More recently, the Iran-United States Claims Tribunal in *Amoco International Finance Corporation v. Iran* dealt with the relationship between the stability of investor-State contracts and the responsibility of the State to attend to the public interest. It presented a balanced approach, but also required the

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209. Oliva (*Italy v. Venez.*), 10 R.I.A.A. 600, 609.

210. *Company General of the Orinoco (Fr. v. Venez.)*, 10 R.I.A.A. 184, 280.

211. *Admin. of Posts and Tel. of the Republic of Czechoslovakia v. Radio Corp. of Am. (Czechoslovakia v. Radio Corporation of America)*, 1932 Hague Ct. (Apr. 1), 30 AM. J. INT'L L. 523, 531 (1936).

212. *Id.*

213. See *Shufeldt Claim (Guatemala v. U.S.)*, 2 R.I.A.A. 1079, 1095 (1929); *Norwegian Shipowners Claims (Norway v. U.S.)*, 1 U.N.R.I.A.A. 307, 338 (1922). See also Weil, *supra* note 3, 101 & 217 *et seq.*

host State to pay compensation for certain interferences. The Tribunal explained that the good faith execution of contracts:

must not be equated with the principle *pacta sunt servanda* often invoked by claimants in international arbitrations. To do so would suggest that sovereign States are bound by contracts with private parties exactly as they are bound by treaties with other sovereign States. This would be completely devoid of any foundation in law or equity and would go much further than any State has ever permitted in its own domestic law. 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.<sup>214</sup>

Quite similarly, the European Court of Human Rights recognized the specific prerogatives of the State in its contractual relations with private individuals. In a case concerning the unilateral termination of a construction contract between a private contractor and Greece's former military government, the Court explained:

The Court does not doubt that it was necessary for the democratic Greek State to terminate a contract which it considered to be prejudicial to its economic interests. Indeed according to the case-law of international courts and of arbitration tribunals any State has a sovereign power to amend or even terminate a contract concluded with private individuals, provided it pays compensation. This both reflects recognition that the superior interests of the State take precedence over contractual obligations and takes account of the need to preserve a fair balance in a contractual relationship.<sup>215</sup>

International courts and tribunals have therefore accepted that under general international law the host State is entitled to interfere with investor-State contracts, if this serves the host State's public interest.<sup>216</sup> This entitlement is, however, regularly

214. *Amoco Int'l Fin. Corp. v. Iran*, 15 Iran-U.S. Cl. Trib. Rep. 189, 242-243 (1987).

215. *Stran Greek Refineries and Stratis Andreadis v. Greece*, 19 Eur. H.R. Rep. 293, 328-29 (1994) (citing *Shufeldt (U.S. v. Guat.)*, 2 R.I.A.A. 1079, 1095).

216. Similarly, international law scholarship accepts this prerogative of the State under customary international law. IGNAZ SEIDL-HOHENVELDERN, *INVESTITIONEN IN ENTWICKLUNGSLÄNDERN UND DAS VÖLKERRECHT* 39-40 (1963); see also RUDOLF L. BINDSCHEDLER, *VERSTAATLICHUNGSMABNAHMEN UND ENTSCHÄDIGUNGSPFLICHT NACH VÖLKERRECHT* 39-40 (1950); FRICK, *supra* note 205, at 52 ("dem besonders eng auszulegenden Prinzip der Opfergrenze, des Selbsterhaltungsrechts des einzelnen Staates"); ALFRED VERDROSS, *VÖLKERRECHT* 412 et seq. (5th ed. 1964); A. F. M. Maniruzzaman, *State Contracts with Aliens: The Question of Unilateral Change by the State in Contemporary International Law*, 9 J. INT'L ARB., Dec. 1992, at 141, 145 (1992) ("The public interest requires that the

subject to a compensation requirement.

## 2. *The State's Power to Interfere with State Contracts under Domestic Laws*

The power of the State to modify or terminate a contract with an individual in the public interest has also been accepted in the major domestic legal systems, lending further support to the conclusion that the power of the State to interfere with investor-State contracts in the public interest constitutes a general principle of law.<sup>217</sup> French administrative law, for example, recognizes that the administration is entitled, if not required, to unilaterally modify so-called *contrats administratifs* in the public interest, subject to the payment of compensation.<sup>218</sup> Similarly, English law has accepted that the State has the power to modify or terminate contracts to which it is a party if a superseding public interest is at play. Following the leading case, *Rederiaktiebolaget Amphitrite v. The King*, English courts consider that “it is not competent for the Government to fetter its future executive action, which must necessarily be determined by the needs of the community when the question arises. It cannot by contract hamper its freedom of action in matters which concern the welfare of the State.”<sup>219</sup> Even though

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governmental authority be empowered to carry out continuous supervision over the execution of the contract and it also authorizes the governmental authority to undertake *certain unilateral powers: to suspend, vary or rescind the contract, to transfer it to another party, or to take it over itself*. The public interest not only authorizes the governmental authority to exercise powers, but also places it under a duty to exercise such powers as part of its responsibility to the public.” (emphasis added); Weil, *supra* note 3 at 101, 217 *et seq.* Cf. Colin C. Turpin, *Public Contracts*, in VII INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW 38 (Konrad Zweigert & Ulrich Drobnig eds., 1981) (“The prerogatives of the administration commonly include a *power of unilateral variation of the conditions of the contract*, such that the contractor may be required to perform more expeditiously, render different services, conform to different specifications, or otherwise depart from the original stipulations of the contract.”) (emphasis added).

216. See also Maniruzzaman, *supra* note 215215, at 146–59. Cf. DOLZER, *supra* note 54, at 213 *et seq.*; Rudolf Dolzer, *Indirect Expropriation of Alien Property*, 1 ICSID REV. 41 (1986) (regarding the interaction between domestic legal systems and general principles of law as a way to clarify customary international law as well as treaty law).

217. Conseil d'Etat [CE] Decisions of March 11, 1910 - *Compagnie générale française des tramways*; Conseil d'Etat, Decisions of Feb. 2, 1983 - *Union des Transports publics*.

219. *Rederiaktiebolaget Amphitrite v. The King*, [1921] 3 K.B. 500, 503; see also COLIN C. TURPIN & A. TOMKINS, *BRITISH GOVERNMENT AND THE CONSTITUTION* 705–07 (6th ed. 2007) (making reference to more recent case law).



the question of compensation for such interferences still seems to be unsettled,<sup>220</sup> English common law accepts that a State cannot contract away its power to interfere with contracts in the public interest. A similar position is endorsed by other common law jurisdictions, such as Australia, New Zealand and Canada.<sup>221</sup>

The power of the State to interfere with contracts based on a police power exception is also accepted under the U. S. Constitution.<sup>222</sup> In the *Blaisdell* case, the U.S. Supreme Court held, concerning a mortgage moratorium imposed during the Great Depression, that:

the reservation of essential attributes of sovereign power is also read into contracts as a postulate of the legal order. The policy of protecting contracts against impairment presupposes the maintenance of a government by virtue of which contractual relations are worth while, – a government which retains adequate authority to secure the peace and good order of society . . . The reservation of this necessary authority of the state is deemed to be part of the contract.<sup>223</sup>

The Court further considered the State's power to interfere with contractual relationships as part of "the police power, [which] is an exercise of the sovereign right of the government to protect the lives, health, morals, comfort and general welfare of the people, and is paramount to any rights under contracts

220. See Rosalyn Higgins, *The Availability of Damages for Reliance by a Government on Executive Necessity*, in INTERNATIONAL LAW AND ECONOMIC ORDER: ESSAYS IN HONOUR OF F. A. MANN ON THE OCCASION OF HIS 70TH BIRTHDAY 21 (Werner Flume et al. eds., 1977).

221. Cf. *Newfoundland and Labrador v. Nova Scotia*, (Can. v. Can.), [2006] 128 Int'l L. Rep. 435, 446 (2001) ("As a general matter, governments cannot under Canadian law validly contract so as to fetter their future executive action . . ."); *Attorney-General for New South Wales v. Quin* (1990) 170 C.L.R. 1, 17 (holding with reference to earlier case law that "[t]he Executive cannot by representation or promise disable itself from, or hinder itself in, performing a statutory duty or exercising a statutory discretion to be performed or exercised in the public interest, by binding itself not to perform the duty or exercise the discretion in a particular way in advance of the actual performance of the duty or exercise of the power"); *Petrocorp Exploration Ltd. v. Minister of Energy*, [1991] 1 N.Z.L.R. 641, 652 (P.C.) (holding with respect to the relationship between contractual obligations and statutory duties that "the contractual fetter would have been ineffective, because it would have been quite incompatible with the proper exercise of the Minister's statutory powers in the national interest").

222. See Bernadette Meyler, *Economic Emergency and the Rule of Law*, 56 DEPAUL L. REV. 539, 558, n.42 (2007).

223. *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 435 (1934). Cf. *Energy Reserves Group v. Kansas Power & Light Co.*, 459 U.S. 400, 410 (1983); *East New York Savings Bank v. Hahn et al.*, 326 U.S. 230, 231 (1945); *Veix v. Sixth Ward Bldg. & Loan Ass'n*, 310 U.S. 32, 38 (1940).

between individuals” and engaged in a balancing process of the competing rights and interests.<sup>224</sup> Although the case concerned contracts between private parties, the Court in *Blaisdell* already implied that its reasoning applied to “all contracts, whether made between States and individuals, or between individuals only.”<sup>225</sup> Subsequently, the Court expressly extended the principle to contracts between States and individuals.<sup>226</sup>

The jurisprudence of international courts and tribunals as well as the situation under several domestic legal systems thus gives broad support to the conclusion that it is a general principle of law that a State has the power to modify or even terminate contracts with private parties in view of a superseding public interest. It is, however, equally recognized that the State has, in principle, to compensate the private individual for damages incurred by such modification or termination depending on how significantly the contractual equilibrium is affected. This power of States is, in fact, so well recognized that it has to be read as an implied exception to the application and operation of umbrella clauses.

### *3. Contract Regulation, Contract Termination, and Opportunistic Behavior*

An implicit police power exception to the operation of the umbrella clause for the regulation of contracts in the public interest can not only be justified by having recourse to the State’s duty to attend to the public interest and to protect rights and interests of third parties. The police power exception can also be justified in economic terms. In many cases, interferences with investor-State contracts based on subsequent regulation concern externalities, i.e. effects on unrelated third parties, which result from the behavior of the investor. Externalities come into existence because the parties to the contract do not assume the full costs of their behavior and therefore act, from an economic perspective, inefficiently.<sup>227</sup> Regulations of the contract by the host State that impose additional obligations or

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224. *Blaisdell*, 290 U.S. at 437 (1934) (quoting *Manigault v. Springs*, 199 U.S. 473, 480 (1905)).

225. *Blaisdell*, 290 U.S. at 435 (quoting *Long Island Water Supply Co. v. Brooklyn*, 166 U.S. 685, 692 (1896)).

226. *United States Trust Co. v. New Jersey*, 431 U.S. 1, 14 (1977); *City of El Paso v. Geenberry Simmons*, 379 U.S. 497, 506–09 (1965).

227. Lewis A. Kornhauser, *An Introduction to the Economic Analysis of Contract Remedies*, 57 U. Colo. L. Rev. 683, 705 (1986).

interfere with established contractual rights can thus be justified by showing that the parties do not assume the full costs of their behavior, but instead impose social costs on third parties.<sup>228</sup> The imposition of additional obligations—through subsequent regulation—to protect the environment, the investor's employees, or not to interfere with competition, can thus be justified from an economic perspective with the externalities created by the parties' behavior.<sup>229</sup> Such regulation of investor-State contracts will therefore not constitute a violation of an umbrella clause that engages the host State's international responsibility for unlawful behavior. By contrast, if the regulation of investor-State contracts constitutes disguised opportunistic behavior of the host State that does not aim at furthering a public interest but at enriching the host State's budget, the State's international responsibility for violation of an umbrella clause will be engaged.<sup>230</sup> It is, thus, necessary to distinguish meticulously between regulatory behavior and opportunism in order to avoid general regulation that is merely used as a pretext to change the contractual equilibrium to the detriment of foreign investors.

A different issue concerns the question of whether the host State, in case of non-opportunistic and thus, as regards the functioning of umbrella clauses, generally permissible regulation of investor-State contracts, has to provide compensation. This will depend on a number of factors, including the importance of the public interest at play, the degree and the consequences of the interference with an investor-State contract, the existence of alternative, less restrictive measures, the question of whether, and to what degree, the investor's behavior harms competing rights and interests, etc. These aspects can come into play via a balancing or proportionality analysis that weighs the public interests against those of the foreign investor.<sup>231</sup> Consequently, the

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228. See Ronald H. Coase, *The Problem of Social Costs*, 3 J. L. & ECON. 1 (1960).

229. Cf. Schwartz, *supra* note 35, at 555.

230. In the event that the host State derives a direct benefit from the regulation one could depart from a refutable presumption that the regulation constitutes opportunistic behavior and thus requires compensation. See *Sedco, Inc. v. NIOC (Iran)*, 9 Iran-U.S. Cl. Trib. Rep. 248, 274-79 (1985), for a parallel case concerning the regulation of property, where the Iran-United States Claims Tribunal established such a presumption.

231. See generally Alec Stone Sweet & Jud Mathews, *Proportionality Balancing and Global Constitutionalism*, Yale Law School Faculty Scholarship Series No. 14 (2008).

termination of investor-State contracts will usually require the host State to provide compensation, unless the termination will only be effective far into the future and thus will allow the investor to recuperate the costs of the investment and derive some benefits from it. Otherwise, compensation is necessary in order to stabilize the host State's original promises and allow for efficient private ordering between investors and States.

In cases of mere regulation of investor-State contracts that do not go as far as termination of the entire contractual arrangement, the question of whether compensation is due may equally be solved based on a proportionality analysis. If the regulation of an investor-State contract that the host State imposes strikes a reasonable and proportionate balance in furthering a legitimate policy goal, for instance the protection of some interest that is external to the investor-State relationship, or aims at avoiding negative externalities on third-parties resulting from the activity of the investor in performing his contractual obligations, and is based on general and non-discriminatory rules, such regulation will, in principle, not require compensation. The situation may be different when the pursuance of a legitimate policy goal requires the imposition of a disproportionate or unreasonable burden for foreign investors or when general regulation has the result of unequally burdening specific investors who are, because of special circumstances, affected more than other investors. In such cases of general regulation imposing "special burdens" on some, but not all investors, compensation may be necessary in order to counterbalance disproportionate burdens.<sup>232</sup>

The argument that umbrella clauses do not remove the power of the host State to terminate or regulate investor-State contracts in the public interests can also be supported by drawing a parallel to the protection of property against expropriation under both customary international law and investment treaties. With regard to both bodies of law, States are entitled to take property of foreign investors based on the State's power of *eminent domain* for a public purpose, implemented in a non-discriminatory manner, and subject to compensation.<sup>233</sup> The same should equally apply to the

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232. Cf. Thomas W. Wälde & Abba Kolo, *Environmental Regulation, Investment Protection and "Regulatory Taking" in International Law*, 50 INT'L & COMP. L.Q. 811, 845-46. (2001) (discussing a similar view in the context of the regulation of property).

233. See RUDOLF DOLZER & CHRISTOPH SCHREUER, PRINCIPLES OF

termination of investor-State contracts, given that it is widely accepted that rights under an investor-State contract constitute property rights that are protected under customary international law.<sup>234</sup> However, just as the host State can exercise its right of *eminent domain* in respect of property rights, it should be able to terminate contracts, provided there is a public interest at play and that the termination does not constitute a discriminatory act against the investor in question.

## V. THE SCOPE OF UMBRELLA CLAUSES

Not only the function of umbrella clauses and their impact on the substantive relations between foreign investors and host States have troubled arbitral tribunals. Another central point of debate in the jurisprudence on umbrella clauses is the scope of application *ratione materiae* of the clauses. The Tribunal in *SGS v. Pakistan*, for example, was decisive in denying that the clause in question constituted an umbrella clause because this:

would [have] amount[ed] to incorporating by reference an unlimited number of State contracts, as well as other municipal law instruments setting out State commitments including unilateral commitments to an investor of the other Contracting Party. Any alleged violation of those contracts and other instruments would be treated as a breach of the BIT.<sup>235</sup>

Similarly, the Tribunal in *El Paso v. Argentina* considered that a broad interpretation of an umbrella clause would indeed cover “the violation of *any legal obligation* of a State, and not only of any contractual obligation with respect to investment.”<sup>236</sup> Other tribunals underscore the breadth of the type of “commitments” covered by umbrella clauses. The Tribunal in *Enron v. Argentina*, for example, considered that “[u]nder its ordinary meaning the phrase ‘any obligation’ refers to obligations regardless of their nature. Tribunals interpreting this expression have found it to cover both contractual obligations such as payment as well as obligations assumed

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INTERNATIONAL INVESTMENT LAW, 89–92 (2008).

234. See Schwebel, *supra* note 65, 409–11; Jennings, *supra* note 58, at 173 n.5 (both citing various cases confirming that contractual rights can form the object of expropriation).

235. *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, ICSID (W. Bank) Case No. ARB/01/13, Decision on Objections to Jurisdiction, para. 168 (Aug. 6, 2003).

236. *El Paso Energy Int'l Co. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/03/15, Decision on Jurisdiction, paras. 71–88 (Apr. 27, 2006).

through law or regulation.”<sup>237</sup>

This section thus considers the scope of application *ratione materiae* of umbrella clauses and develops it from the function of the clauses to allow for private ordering between investors and host States in the investment-related context. Against this background, it is argued that umbrella clauses cover the enforcement of all investment-related promises of the host State that are either contractual in nature or constitute a functional substitute for an investor-State contract. What this section therefore stresses is the connection between the operation of umbrella clauses and the scope of application of investment treaties *ratione materiae*.

#### A. THE PROTECTION OF CONTRACTUAL PROMISES AND THE NOTION OF INVESTMENT

Investor-State contracts are—without doubt—covered by the scope of application of an umbrella clause because the host State’s promise made in them is the basis for the performance of the investor’s obligation. Its enforcement is necessary to enable efficient and effective investor-State cooperation. Accordingly, non-observance by the host State of investor-State contracts has posed little difficulty in arbitral practice and is considered to be covered by umbrella clauses.<sup>238</sup> In *Fedax v. Venezuela*, for instance, promissory notes were considered to be covered by an umbrella clause.<sup>239</sup> Similarly, the Tribunal in *SGS v. Philippines* held that an umbrella clause “includes commitments or obligations arising under contracts entered into by the host State.”<sup>240</sup> Likewise other tribunals considered that umbrella clauses cover “[c]onsensual obligations . . . with regard to, and

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237. *Enron Corp. and Ponderosa Assets L.P. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/01/3, Award, para. 274 (May 22, 2007).

238. See *LG&E Energy Corp. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/02/1, Decision on Liability, paras. 170–74 (Oct. 3, 2006); *Noble Ventures, Inc. v. Romania*, ICSID (W. Bank) Case No. ARB/01/11, Award, paras. 51 (Oct. 12, 2005) (“[C]onsidering the wording of Art. II (2)(c) which speaks of ‘any obligation [a party] may have entered into with regard to investments’, it is difficult not to regard this as a clear reference to investment contracts.”).

239. *Fedax N.V. v. Republic of Venezuela*, ICSID (W. Bank) Case No. ARB/96/3, Award, para. 29 (Mar. 9, 1998).

240. *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, ICSID Case No. ARB/02/6, Decision on Objections to Jurisdiction, para. 127 (Jan. 29, 2004).

as between, obligor and obligee,"<sup>241</sup> "contractual arrangements,"<sup>242</sup> and "investment contracts."<sup>243</sup>

An umbrella clause does not, however, cover every contractual obligation between foreign investor and host State. Instead, the contract entered into by the host State has to qualify as an investment in the sense of the applicable investment treaty. Although this will often be the case with respect to contracts between a foreigner and the State, the notion of investment excludes non-investment-related contracts, such as contracts about the sale of goods between an investor and the host State, from the protection of investment treaties and umbrella clauses. An investor selling and delivering goods, such as school benches or railroad machinery across the border, while entering into a contract with a foreign State, cannot avail itself of the protection of an investment treaty, because trans-border sales contracts do not qualify as investment.<sup>244</sup> Instead, it is necessary that there be at least some connection to the territory of the host State in the form of an establishment<sup>245</sup> and submission to the power of the host State.<sup>246</sup>

The restriction of the protection of umbrella clauses to investment-related contracts has also been recognized in the arbitral jurisprudence. It has been referred to by several tribunals that noted that umbrella clauses only protected obligations or undertakings with regard to investments.<sup>247</sup> While

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241. CMS Gas Transmission Co. v. Argentine Republic, ICSID (W. Bank) Case No. ARB/01/8, Decision on Annulment, para. 95(b) (Sept. 25, 2007).

242. *Eureko*, Partial Award, *supra* note 6, para. 250.

243. *Noble Ventures*, ICSID Case No. ARB/01/11, at para. 51; *see also* SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan, ICSID (W. Bank) Case No. ARB/01/13, Decision on Objections to Jurisdiction, paras. 162–73 (Aug. 6, 2003) (supporting that contractual arrangements would fall under the scope of application of an umbrella clause); *cf.* Cont'l Cas. Co. v. Argentine Republic, ICSID (W. Bank) Case No. ARB/03/9, Award, para. 297 (Sept. 5, 2008).

244. *See* sources cited *supra* note **Error! Bookmark not defined.**

245. *Cf.* SGS v. Philippines, ICSID Case No. ARB/02/6, at para. 99.

246. *Cf.* Bayview Irrigation Dist. v. Mexico, ICSID Case No. ARB(AF)/05/1, Award, paras. 93–103 (June 19, 2007); DOLZER & SCHREUER, *supra* note 233, at 60–71; Yves G. L. Wolters, *The Meaning of "Investment" in Treaty Disputes: Substantive or Jurisdictional?— Lessons from Nagel v. Czech Republic and S.D. Myers v. Canada*, 8 J. WORD INV. & TRADE 175, (2007); Farouk Yala, *The Notion of "Investment" in ICSID Case Law: a Drifting Jurisdictional Requirement? Some "Un-Conventional" Thoughts on Salini, SGS and Mihaly*, 22 J. INT'L ARB. 105, 117–20 (2005).

247. Duke Energy Electroquil Partners & Electroquil S.A. v. Republic of Ecuador, ICSID (W. Bank) Case No. ARB/04/19, Award, para. 325 (Aug. 18, 2008); Enron Corp. and Ponderosa Assets L.P. v. Argentine Republic, ICSID (W. Bank) Case No. ARB/01/3, Award, paras. 273–74 (May 22, 2007); Siemens A.G. v.

most cases involving application of umbrella clauses clearly concerned investment-related contracts, the decision in *Joy Mining v. Egypt* may elucidate the restriction of umbrella clauses to investment-related contracts. Here, the Claimant invoked, *inter alia*, a breach of the umbrella clause in the British-Egyptian BIT based on the breach of an agreement with an Egyptian State agency concerning delivery and installation of longwall mining systems. In the case at hand, a dispute arose after the Claimant installed the equipment as to whether the performance of the investor's obligations had been in accordance with the contract. Alleging that the Claimant had not performed its contractual obligations satisfactorily, the agency refused to release bank guarantees that had been given by the Claimant in order to secure the performance of its obligations.

The Tribunal, however, held that neither the bank guarantees nor the underlying contract qualified as an investment under Art. 25(1) of the ICSID Convention, because they were rather comparable to simple sales contracts and declined its jurisdiction *ratione materiae*.<sup>248</sup> In this context, it also commented on the Claimant's reliance on the umbrella clause as establishing jurisdiction for alleged contractual breaches. It stated:

In this context, it could not be held that an umbrella clause inserted in the treaty, and not very prominently, could have the effect of transforming all contract disputes into investment disputes under the Treaty, unless of course there would be a clear violation of Treaty rights and obligations or a violation of contract rights of such a magnitude as to trigger the Treaty protection, which is not the case.<sup>249</sup>

These observations might be interpreted, and in fact have been, as supporting a restrictive reading of the function of an umbrella clause as requiring a substantial interference with contractual rights or interference by the host State with a contract in its quality as a sovereign.<sup>250</sup> It seems, however,

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Argentine Republic, ICSID (W. Bank) Case No. ARB/02/8, Award, para. 206 (Feb. 6, 2007); *Noble Ventures*, ICSID Case No. ARB/01/11, at para. 51; LG&E Energy Corp. v. Argentine Republic, ICSID (W. Bank) Case No. ARB/02/1, Decision on Liability, paras. 169–75 (Oct. 3, 2006); *Eureko*, Partial Award, *supra* note 6, para. 246.

248. *Joy Mining Machinery Limited v. Egypt*, ICSID (W. Bank) Case No. ARB/03/11, Decision on Jurisdiction, paras. 41 *et seq.* (July 30, 2004).

249. *Id.* para. 81.

250. See *El Paso Energy Int'l Co. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/03/15, Decision on Jurisdiction, paras. 78–79 (Apr. 27, 2006); *Pan American Energy LLC, and BP Argentina Exploration Co. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/03/13, and *BP America Production Co., Pan American Sur SRL, Pan American Fuegoína, SRL and Pan American Continental SRL v.*



questionable whether the above quoted statement of the Tribunal in *Joy Mining* actually supports such a reading. Certainly, the passage is not a model of clarity as to the meaning the Tribunal wants to convey. Yet, instead of reading it as expressing the view that umbrella clauses only protect against sovereign breaches of investor-State contracts, the quoted paragraph arguably makes much more sense if it is read as a rejection of the argument that umbrella clauses establish jurisdiction of an investment tribunal for any contractual claims, independent of the subject matter of the contract and the scope of application *ratione materiae* of the investment treaty. What the passage then emphasizes is that umbrella clauses do not grant treaty-based jurisdiction for breaches of non-investment-related contracts. Consequently, an umbrella clause does not broaden the subject matter jurisdiction of treaty-based tribunals beyond the limits of what constituted protected investment under the respective investment treaty.

Similarly, many contracts between a host State and a foreign investor might not qualify as investment agreements or investment-related contracts, even if the foreigner has a presence in the host State. A contract of the ministry of a host State concerning the purchase of cars produced by a foreign investor in the host State, for example, will not come under the definition of an investment for purposes of the umbrella clause, because the contract is not investment-related, but a contract over the sale of goods that does not concern the investor's investment.<sup>251</sup> While unilateral modification or termination of such contracts could possibly constitute a violation of other investor's rights, namely the fair and equitable treatment standard, a claim for the breach of such contracts cannot be brought as a violation of an umbrella clause. This limitation is, however, not due to the limitation of the umbrella clause to breaches of a sovereign nature, but because a non-investment-related contract is not covered by the scope of application of the umbrella clause. The concern that the umbrella clause transforms the violation of any contractual agreement into an

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Argentine Republic, ICSID (W. Bank) Case No. ARB/04/8 (consolidated claims), Decision on Preliminary Objections, paras. 107–08 (July 27, 2006) (both claiming that this is the content of the statement of the Tribunal in *Joy Mining v. Egypt*).

251. Cf. *SGS v. Philippines*, ICSID Case No. ARB/02/6, para. 99 (“For example the construction of an embassy in a third State, or the provision of security services to such an embassy, would not involve investments in the territory of the State whose embassy it was, and would not be protected by the BIT.”).

investment dispute is therefore ill-founded. Instead, much of the purely fiscal contracting of States will not fall under the notion of investment and therefore be outside the scope of application of an umbrella clause. Consequently, investment treaty arbitration will not be available in case of breach of such contracts.

## B. UMBRELLA CLAUSE AND UNILATERAL PROMISES BY THE HOST STATE

The scope of operation of umbrella clauses is, however, not limited to contractual promises of the host State contained in investor-State contracts. Instead, it arguably also encompasses other specific promises the host State made in its national legislation, by means of individual administrative instruments, and the like. In fact, in many legal systems the State acts vis-à-vis private individuals and provides legal security and stability for large-scale investment projects, not through contractual arrangements, but by means of unilateral public law licenses that are passed on the basis of a general law. In Germany, for example, even the operation of public utilities, such as waste landfills or nuclear power plants, is often not conducted on the basis of investor-State contracts that set out the mutual rights and obligations. Instead, the competent administrative agencies unilaterally grant, based on the governing statutory law, a license that authorizes the individual's activity in question.<sup>252</sup> Similarly, specific promises to investors are sometimes directly contained in domestic legislation, such as legislative promises granting special tax benefits over a significant number of future years for specific investments in order to encourage them.

The question therefore arises whether the breach of such non-contractual promises can also give rise to the host State's liability for a violation of an umbrella clause or whether, in turn, umbrella clauses are limited to breaches of investor-State contracts in the strict sense of the term. The more convincing arguments militate for a broad substantive coverage of umbrella

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252. The public law instrument used in this context is an administrative act (*Verwaltungsakt*), a unilateral decision that grants or imposes rights and duties upon individuals in concrete cases. See *Verwaltungsverfahrensgesetz* [VwVfG] [Administrative Law Code], § 35. Contractual relationships between the State and private enterprises, on the other hand, are rarer, although the German Administrative Law contains the instrument of the public law contract and makes use of it increasingly. See *id.* §§ 54–62.

clauses, covering not only contractual promises but also administrative acts and promises contained in domestic legislation. While the precise wording of the umbrella clause in question is, of course, determinative, the clauses are regularly worded broadly as applying to the observance of "commitments" or "obligations" that the host State has entered into vis-à-vis foreign investors without limitations to contractual obligations or commitments.

Furthermore, the functional understanding of umbrella clauses as backing up private ordering between host States and foreign investors also militates for a broad scope of application *ratione materiae* of the clauses. What is decisive from this perspective is not the form of the host State's commitment, but whether it is at the basis of an investment-related and transaction-specific relationship between the foreign investor and the host State, independent of its legal basis in an investor-State contract, a concession, a license, an administrative act, or legislation. Instead from an economic perspective, it makes no difference whether an investor starts carrying out a specific investment on the basis of an investor-State contract or a specific commitment of the host State in another legal instrument.<sup>253</sup> As long as the administrative or legislative promise by the host State was the reason an investment was made and was intended to induce such investment, such promises should, just like contractual promises, qualify as commitments for the scope of application of umbrella clauses. It must be born in mind, however, that the regulatory and legislative framework underlying the granting of individual administrative acts usually contains grounds for revocation. These grounds become part of the legal framework governing relations between the investor and the host State and may allow revocation of a license without a breach of the host State promise.<sup>254</sup>

A broad interpretation of the type of commitments covered by an umbrella clause is also shared by most of the arbitral jurisprudence. It emphasizes—the wording of the umbrella

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253. See GEORG SCHWARZENBERGER, DER SCHUTZ VON AUSLANDSINVESTITIONEN 16 (1969) (considering that the essence not the form is decisive in the context of public contracts).

254. However, the guarantee of fair and equitable treatment may offer relief, for example, if the revocation is disproportionate, the host State misused its discretion in revoking a license, or did not grant due process. See Schill, *supra* note 13, at 24-26.

clause in question permitting—that any commitment independent of its legal basis can be covered by an umbrella clause as long as it is of a specific and investment-related character. In *SGS v. Philippines*, for example, the Tribunal considered that commitments covered by the umbrella clauses “must have assumed a legal obligation, and it must have been assumed vis-à-vis the specific investment—not as a matter of the application of some legal obligation of a general character.”<sup>255</sup> Similarly, as the Annulment Committee in *CMS v. Argentina* pointed out, the commitments covered by an umbrella clause must constitute “specific obligations concerning the investment. They do not cover general requirements imposed by the law of the host State.”<sup>256</sup>

The irrelevance of the legal basis of the commitment is also confirmed by the Decision on Liability in *LG&E v. Argentina*, where the Tribunal considered that a specific tariff regime contained in the regulatory and legislative framework for the Argentine gas distribution sector was covered by the umbrella clause in the US-Argentine BIT. The Tribunal argued:

In order to determine the applicability of the umbrella clause, the Tribunal should establish if by virtue of the provisions of the Gas Law and its regulations, the Argentine State has assumed international obligations with respect to LG&E and its investment. . . . Argentina made these specific obligations to foreign investors, such as LG&E, by enacting the Gas Law and other regulations, and then advertising these guarantees in the Offering Memorandum to induce the entry of foreign capital to fund the privatization program in its public service sector. These laws and regulations became obligations within the

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255. *SGS v. Philippines*, ICSID Case No. ARB/02/6, at para. 121; *see also* Enron Corp. and Ponderosa Assets L.P. v. Argentine Republic, ICSID (W. Bank) Case No. ARB/01/3, Award, paras. 274–76 (May 22, 2007); *Siemens A.G. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/02/8, Award, para. 206 (Feb. 6, 2007); *Noble Ventures, Inc. v. Romania*, ICSID (W. Bank) Case No. ARB/01/11, Award, para. 51 (Oct. 12, 2005); *Eureko*, Partial Award, *supra* note 6, para. 246 (“‘Any’ obligation is capacious; it means not only obligations of a certain type, but ‘any’—that is to say, all—obligations entered into with regard to investments of investors of the other Contracting Party.”). *Cf.* *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, ICSID (W. Bank) Case No. ARB/01/13, Decision on Objections to Jurisdiction, para. 166 (Aug. 6, 2003) (“The ‘commitments’ the observance of which a Contracting Party is to ‘constantly guarantee’ are not limited to contractual commitments. The commitments referred to may be embedded in, e.g., the municipal legislative or administrative or other unilateral measures of a Contracting Party.”) (internal citation omitted).

256. *Cf.* *Cont’l Cas. Co. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/03/9, Award, para. 297–302 (Sept. 5, 2008); *CMS Gas Transmission Co. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/01/8, Decision on Annulment, para. 95 (Sept. 25, 2007).

meaning of Article II(2)(c), by virtue of targeting foreign investors and applying specifically to their investments, that gave rise to liability under the umbrella clause.<sup>257</sup>

What is decisive for a commitment to be covered is whether the host State's act contains a specific commitment that serves as a functional substitute for an investor-State contract.<sup>258</sup>

While determination of whether a legislative commitment is specific enough to constitute a commitment covered under an umbrella clause will depend on the specific circumstances of the case, it will usually be necessary for the legislative commitment to confer specific and individual rights upon investors as an incentive to invest, or make specific promises in return for certain actions an investor engages in. This is the case, for example, if the host State passes general legislation that intends to promote investments in a specific economic sector and is fully aware that the stability of the legislative promise is the precondition for investors to engage in the desired activity. What will, by contrast, not be sufficient as constituting a commitment covered by an umbrella clause are rules of the general legal framework that merely aim at regulating certain investment activities without intending to create reliance of the investor in the stability of this framework or intending to create a deliberate incentive for certain investment activities.

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257. *LG&E Energy Corp. v. Argentine Republic*, ICSID (W. Bank) Case No. ARB/02/1, Decision on Liability, para. 174 (Oct. 3, 2006) (citing *v. Philippines*, ICSID Case No. ARB/02/6, at para. 121, concerning the juxtaposition of general and specific commitments).

257. See also FRICK, *supra* note 206, at 205 ("Die Vertragsstaaten sichern sich gegenseitig zu, auch solche nicht-völkerrechtliche Verpflichtungen einzuhalten, die sie in Bezug auf Kapitalanlagen von Investoren der anderen Vertragspartei in ihrem Hoheitsgebiet übernommen haben. Damit sind all die einseitigen oder auf Grund vertragsähnlicher Vereinbarungen gemachten Zusagen staatlicher Zulassungsstellen angesprochen. Die speziellen Verpflichtungen, die eine Einzelstaat gegenüber einem ausländischen Investor im Interesse der Förderung der nationalen Wirtschaft übernimmt, werden in dieser Weise ihrem Inhalt und Bestand nach völkerrechtlich abgesichert, auch soweit sie ausschließlich auf innerstaatlichem Recht beruhen und nicht in irgendeiner Form, internationalisiert' sind.") (footnotes omitted). Recent Swiss investment treaty practice also confirms that umbrella clauses do not only intend to cover contractual promises of host States vis-à-vis foreign investors but also specific obligations and promises stemming from national legislation, international agreements, or undertakings under administrative law. See MICHAEL SCHMID, *SWISS INVESTMENT PROTECTION AGREEMENTS: MOST-FAVOURLED-NATION TREATMENT AND UMBRELLA CLAUSES* 63 (2007).

## VI. CONCLUSION: TAMING THE SPIRITS

The application and interpretation of umbrella clauses have posed significant problems for arbitral tribunals and brought about incompatible and conflicting decisions. Inconsistencies have arisen with respect to the construction of umbrella clauses, the scope of commitments covered by them, the effect of the clauses on the jurisdiction of treaty-based tribunals, and their effects on the regulatory power of States regarding investor-State cooperation. Above all, what has been unsettled since arbitral tribunals began applying umbrella clauses is their function and relation to customary international law, with its limited protection of investor-State contracts. In this regard, it is essentially two views that compete. One regards the clauses as a codification of customary international law that merely clarifies that investor-State contracts are protected against expropriatory conduct. Consequently, umbrella clauses in this view require that the host State engages in conduct *à titre de souverain* in breaching one of its earlier promises vis-à-vis the foreign investor. The opposite position attributes a more expansive function to umbrella clauses. In this view, the clauses allow investors to bring a claim for the violation of an investment treaty based on the breach of an investment-related promise by the host State, independent of whether the breach was based on sovereign or commercial conduct.

This article argues that the more restrictive view that requires host State conduct *à titre de souverain* is unconvincing and does not give a convincing account of the function of umbrella clauses, since the protection against sovereign conduct is already afforded by other investors' rights, in particular by the protection against direct and indirect expropriation and the fair and equitable treatment standard. The restrictive approach thus turns umbrella clauses into superfluous treaty provisions. Furthermore, arguments concerning the historical emergence of umbrella clauses suggest that the clauses were intended to serve a proper function in filling gaps resulting from the traditional dualist conception of international law that distinguished categorically between international law and national law, the investor-State and the inter-State relations, as well as claims for the breach of contracts and treaties. The function of umbrella clauses, it was argued, thus consists in opening recourse to an international dispute settlement forum in order to enable investors to enforce contractual and quasi-contractual promises made by the host State and to counter

opportunistic behavior of the host State that can undermine the initially-struck bargain, independent of whether the host State's breach was based on commercial or sovereign conduct. By providing a forum for settling disputes arising out of investor-State relations, umbrella clauses therefore enable effective and comprehensive "private ordering" between investors and host States because the investor is in a position to enforce promises made by the State and have a sanction imposed in the form of damages in case they are breached. As regards their scope of application *ratione materiae*, this article argues that umbrella clauses cover specific promises by host States contained in investor-State contracts, but also those quasi-contractual commitments under domestic law, including administrative law instruments and legislation, that specifically aim at inducing certain investment-related activity and are thus functionally equivalent to an investor-State contract.

Viewing the function of umbrella clause in enabling "private ordering" in investor-State relations can also be supported with arguments stemming from an economic analysis of what institutional infrastructure is necessary in order to allow for efficient investor-State cooperation. Efficient cooperation between investors and host States, it was argued, requires above all the immunization of the contractual relationship against opportunistic behavior of the host State, independent of whether it materializes in sovereign or commercial conduct, through institutionalizing structures of *ex post* control and governance by third-party dispute settlement. While customary international law as well as investment treaty standards such as the guarantee of fair and equitable treatment or the concept of indirect expropriation already protected foreign investments, including investor-State contracts, against interference of a sovereign nature, breaches of investor-State contracts based on commercial conduct of the host State were left uncovered under international law. Consequently, it was argued that umbrella clauses aimed at closing this gap in protection by stabilizing investor-State cooperation *ex post* by offering effective enforcement mechanisms on the level of international law in order to counter opportunistic host State behavior of both sovereign and commercial nature. The more restrictive approach that limits the scope of application of umbrella clauses to contract breaches *à titre de souverain*, by contrast, fails to provide the enforcement mechanisms necessary to counter opportunistic behavior by host States with respect to simple,

commercial breaches that do not involve sovereign conduct.

While this enforcement function of umbrella clauses reinforces the principle of *pacta sunt servanda* for the host State's commitments vis-à-vis the foreign investor, it does not alter the legal nature of the relationship between investor and host State. Umbrella clauses do not transform breaches of commitments under domestic law into breaches of international law; they merely open recourse to investment treaty arbitration in order to enforce host State promises that are governed by municipal law, or whatever law is chosen by the parties. Whether a host State has made a specific commitment and whether this commitment has been breached is determined purely according to the law governing the relations between the investor and the host State, not by the umbrella clause. Similarly, umbrella clauses are limited to targeting *opportunistic* behavior of host States and do not prohibit non-opportunistic behavior, such as the alteration of host State promises in view of future contingencies that affect the relationship between foreign investor and host State, nor do they influence the filling of gaps that become apparent in investor-State relations. Consequently, umbrella clauses do not exclude exceptions to the sanctity of contracts based on doctrines of change of circumstances, *force majeure*, or necessity, nor do they exclude the State's police power to regulate or even terminate investor-State contracts in the public interest, subject to a compensation requirement depending on the circumstances.

With respect to the substantive protection they offer, umbrella clauses do not impose stricter standards upon the observance of commitments by States vis-à-vis aliens than customary international law. They do, however, provide an international forum for the settlement of disputes arising out of the breach of a host State's promise vis-à-vis a foreign investor which encompasses not only breaches that were traditionally considered to constitute violations of customary international law, but offer dispute settlement and enforcement for any breaches of host State promises. Access to treaty-based arbitration for such disputes is determined independently by the obligation of the host State under the umbrella clause to observe commitments vis-à-vis foreign investors. Jurisdiction of treaty-based tribunals, it was argued, can also not be excluded by forum selection clauses entered into in the investor-State relations as the claims for the violation of the umbrella clause constitute a treaty claim even though it is closely connected to a



claim for the breach of contracts. Overall, the primary function of umbrella clauses is thus of a procedural and institutional nature by establishing the jurisdiction of treaty-based arbitral tribunals for enforcing promises the host State made vis-à-vis a foreign investor. In this regard, umbrella clauses break with the limited protection granted to investor-State contracts under customary international law by comprehensively opening recourse to investor-State dispute settlement in an international forum. They do not, by contrast, restrict the host State's sovereign powers in regulating investor-State relations in the public interest.

The function of umbrella clause suggested in this article will also not open the floodgates to an uncontrollable number of investor-State disputes, a fear that seems to heavily influence those tribunals that endorse the restrictive approach to the interpretation of umbrella clauses. First, it needs to be recalled that umbrella clauses only establish jurisdiction for the breach of investment-related host State promises. They do not allow investors to bring a claim based on the violation of domestic law in general. Nor do they establish jurisdiction of investment tribunals for breaches of every contract between foreigners and host States. Rather, the scope of application of umbrella clause is limited to promises that are related to assets and activities of foreign investors that qualify as "investment" under the respective investment treaty. Secondly, umbrella clauses do not exclude host State regulation of contingencies outside of the scope of risk allocation of the investor-State relation and do not curtail the powers of States to regulate investor-State contracts in the public interest. Finally, a broad understanding of umbrella clauses will not lead to flooding investment tribunals with trivial disputes. Instead, investors will have to determine whether the value of the claim for breach of an umbrella clause is sufficient to justify the cost risk connected to investment treaty arbitration.

Instead, the prospect of having investment treaty arbitration available as an independent and efficient dispute settlement forum in order to hold States to their investment-related promises is a well-defined function of umbrella clauses that does not risk developing unexpected and uncontrolled extension of investor-State arbitration. Instead, States can control whether they will risk having to respond to an investment treaty claim based on the violation of an umbrella clause. On the one hand, they do not have to enter into any

contract or other specific commitment vis-à-vis foreign investors; on the other hand, they control whether to abide by their promises or to escape from them out of opportunism. Nothing more, but nothing less, than enabling investors to enforce investment-related promises that host States have made is what umbrella clauses intend. They therefore impose predictable consequences and help to hold States accountable for breaches of promises they made vis-à-vis foreign investors. The clauses are thus not the *Zauberlehrling's* spirits that branch out without control when they are understood as part of an overarching framework for enabling and stabilizing private ordering in investor-State relations, and for enhancing efficient investor-State cooperation.

