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## Responsibility of a Host State in Transnational Investment Disputes

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### Abstract:

The article seeks to define the legal nature of the responsibility of a host state in transnational investment disputes. It considers numerous rules (treaties, national law, customs, soft law, etc.) and their application within a domestic legal system to ensure the proper implementation of civil and other legal rights and obligations of host states and foreign investors. It is argued that the involvement of foreign investors and host states in international commercial arbitration, including the ICSID, and the application of international law (along with national law) as a legal ground for the payment of compensation, do not change the nature of the existing legal relationship between the parties of the investment dispute. The responsibility of the host state to the foreign investor expressed in the state's obligation to pay damages (compensation) remains in the private, rather than international public law sphere. In conditions of lack of proper rules of investment law states should not stand aside from the present process of making such rules by non-state actors. This situation detracts from the treaty as a major source of international law, sometimes does not correspond to the interests of host states and moreover may threaten their sovereignty.

**Keywords:** transnational investment disputes; responsibility of a host state; foreign investments; civil responsibility; investment disputes; international investment law; investment legislation of the Russian Federation.

**JEL Classification:** K12; K13; K40.

### Introduction

In recent years a great number of multilateral and bilateral investment treaties have been concluded. All of them contain a set of interrelated rules of international law, public and private in their sense. They are considered significant in scope and to form international investment law as a separate branch of international law (Likashuk, Velyaminov).

In spite of the multiplicity of current investment treaties, their provisions, including the issues of responsibility of a host state, differ in the contents, require further details, sometimes contradict the other rules of international law, and thus do not provide the necessary international regulation of investment relations. It also concerns the responsibility of a host state before a foreign investor, which is defined in accordance with not only international, but also national law of a particular state. In this regard the legal nature of such responsibility and the order of its application need to be carefully examined.

Furthermore, instead of states as the main creators of international law, many existing legal gaps are being filled by other actors, in particular, international organizations (UN, UNCITRAL, UNCTAD, World Bank, OECD, ICC, etc.) and international commercial arbitrations, first of all, the International Centre for Settlement of Investment Disputes (ICSID). States, including the Russian Federation, which have not *ratified and joined yet to the Convention on Settlement of Investment Disputes between States and Nationals of Other States (1965) (the Washington Convention) (Convention on Settlement of Investment Disputes between States and Nationals of Other States 1965), the Energy Charter Treaty (1994) (ECT) (Energy Charter Treaty 1994), and other universal treaties*, shall

not remain outside from the present process of globalization and development, the increasing role of international law and the subordination of host states to rules, which are not admitted by them. Especially it is problematic for states involved in legal disputes with foreign investors.

### 1. Legal Framework for Settlement of Transnational Investment Disputes

The legal regulation of transnational investment relations is fulfilled on international and national levels. At present the main universal treaties are the Washington Convention, the Seoul Convention Establishing the Multilateral Investment Guarantee Agency (1985) (the Seoul Convention) (Seoul Convention Establishing the Multilateral Investment Guarantee Agency 1985) and ECT, which regulate a separate set of investment relations. Of course, among them the Washington Convention has the key meaning. It stipulates international procedures of conciliation and arbitration for the settlement of investment disputes between states and nationals of other states at ICSID. Its main value, as it is truly pointed out in the legal literature (Sella 1973) is that it has created legal conditions for the withdrawal of a home state from implementing its right of diplomatic protection of its investors and allowed to transfer investment legal disputes from the sphere of international public law into private law.

The Seoul Convention establishing Multilateral Investment Guarantee Agency (MIGA) is designed for issuing guarantees to investors, including coinsurance and reinsurance, against non-commercial risks in respect of investments in developing countries. Since its creation, the number of MIGA guarantees has grown many times and reached 45 with the total of US \$ 1.4 billion in 2007. The majority of supported investments projects is now fulfilled in infrastructure (41%) mainly in Africa and Asia (<http://www.miga.org/>).

ECT contains provisions on the promotion and protection of investments in the energy sector. Usually they can be found in most bilateral agreements for the promotion and reciprocal protection of investments and concern namely most favor nation or national treatment, payment of prompt, adequate and effective compensation for any expropriated assets, the freedom of transfers of revenues related to investments from a host country, the order of the settlement of investment disputes, etc. However, they contain more detailed rules providing, from the one hand, additional guaranties for foreign investors, especially in jurisdictional issues, and, the other hand, appropriate obligations of host states. As it is showed in the literature (Suleimenov 2006), any state with huge energy resources, unlike other participants of ECT, must be ready to accept the limitation of its sovereign rights in case of accession to ECT.

Regional investment treaties are usually concluded within different economic unions of states. They are, for example, European Union (EU), North American Free Trade Agreement (NAFTA), Association of Southeast Asian Nations (ASEAN). The countries of the former Soviet Union are now legally bound with international obligations under the Commonwealth of Independent States (CIS), the members of which are Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan. In 2014 three countries, Belorussia, Kazakhstan and Russia, have founded Eurasian Economic Union (EEU) for implementing deeper economic integration among them. The Treaty on EEU (2014), to which Armenia and Kyrgyzstan joined later, provided for the legal framework for the regulation of trade in services, establishment, functioning and performing investments in member states (Annex No 16 to the Treaty on EEU).

The greatest part of international investment treaties is formed by bilateral agreements on encouragement and mutual protection of capital investments. Their broad conclusion by many states is caused by two circumstances. Firstly, developing countries are interested in attraction of foreign investments. Secondly, foreign investors need clear and stable rules of law which can be guaranteed to them only on the international level. Meanwhile national law can be changed at any time according to advantages and interests of a host state.

Such treaties usually contain: (a) definitions; (b) the protection of capital; (c) treatment for foreign investors (most favor nation or national regime); (d) expropriation; (e) damages; (f) the transfer of payments; (g) subrogation; (h) the settlement of disputes between a contracting state and an investor of the other contracting state; (i) the settlement of disputes between contracting states; (k) consultations; (l) the application of the treaty; (m) the entry into force and duration of the treaty. At present the total number of concluded treaties exceeds 2500. The Russian Federation, for example, is a party to more than 40 such treaties with many developed and developing countries, such as Germany, Great Britain, Canada, China, France, India, Italy, Japan, the Netherlands, South Korea, Switzerland, and others.

There are also bilateral treaties for the avoidance of double taxation with respect to taxes on income and on capital, which is of importance for foreign investor to make a decision to invest abroad. By the moment the Russian Federation has signed more than 50 such agreements with countries, such as Australia, Canada, China, Cyprus, France, Germany, Great Britain, India, Israel, Italy, Japan, South Korea, Switzerland, USA, and others.



In spite of huge number of investment treaties, the national law of a host state is presumed to remain a key source of law applicable to transnational investment disputes. The matter is that investment treaties, indeed, regulate a limited list of issues, require further details and thus need to be supplemented by other rules of law, first of all, appropriate national law. For this reason it becomes clear why the Washington Convention in Article 42(1) emphasizes the application of, first of all, the national law of a host state and then some rules of international law: *'The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties. In the absence of such agreement, the Tribunal shall apply the law of the Contracting State party to the dispute (including its rules on the conflict of laws) and such rules of international law as may be applicable'* (Convention on Settlement of Investment Disputes between States and Nationals of Other States 1965).

Unfortunately, the present investment legislation of the Russian Federation is unsystematic and fragmentary. A lot of special federal, regional and municipal laws, e.g. Federal Law of 25 February 1999 No 39-FZ 'On Investment Activities in the Russian Federation in the Form of Capital Investments' [10], Federal Law of 9 July 1999 No 160-FZ 'On Foreign Investments in the Russian Federation', Federal Law of 21 July 2005 No 115-FZ 'On Concession Agreements', Federal Law of 13 July 2015 No 224-FZ 'On Public-Private Partnership, Municipal-Private Partnership in the Russian Federation and the Amendments to Certain Legislative Acts of the Russian Federation', do not mean the effectiveness of their implementation.

In particular, along with codes and other federal laws they are subject to frequent and inconsistent changes, which lead to their controversy. They provide no unified and incisive legal definition of investment, consistent with the main categories of civil law that can distinguish investment relations from other ones. The specific features of conclusion, performance, amendment and termination of investment contracts, including with a host state, are not properly determined. Most guarantees established for investors are declarative and require more detailed legal provisions. Due to the insufficient competitiveness of the Russian legal system, Russian and foreign investors tend to remove their cases from the legal regulation and jurisdiction of the Russian Federation that proves the importance for the improvement of the Russian legislation in general as well as the investment legislation of the Russian Federation in particular.

The relationship between a foreign investor and a host state may also be governed by so-called 'soft law', which is expected to be applied in case of the consent of the parties of an investment dispute. Unlike hard law, soft law is usually defined as a set of rules adopted mostly by non-state actors, which have no obligatory legal effect or contain no strict and precise responsibilities of states. They are UN General Assembly resolutions, codes of conduct and other acts, including treaties and other international instruments, which stipulate just the cooperation and joint efforts of states and do not require taking any specific commitments from states. For example, in the area of international investment law they are: UN General Assembly Resolution of 14 December 1962 No 1803 (XVII) 'Permanent sovereignty over natural resources', UN General Assembly Resolution of 12 December 1974 No 3281 (XXIX) 'Charter of economic rights and duties of states', World Bank Guidelines on the Treatment of Foreign Direct Investment (1992), OECD Declaration on International Investment and Multinational Enterprises (2011 version), ICC Guidelines for International Investments (2012 version), OECD Code of Liberalisation of Capital Movements (2013 version), etc.

In addition it should be noted that in recent years the role of international commercial arbitrations (first of all, ICSID) in making rules for foreign investors and host states has increased significantly. *Salini Costruttori S.P.A. and Italstrade S.P.A. v. the Kingdom of Morocco* (ICSID Case No. ARB/00/4) (*Salini Costruttori S.P.A. and Italstrade S.P.A. v. the Kingdom of Morocco*), is likely to be a good example to that. In this case ICSID tribunal pointed out the absence of any definition of investment in the Washington Convention and defined four attributes of an investment (*Salini Test*), which began to be used subsequently in some other investment disputes (*Saipem S.p.A v. the People's Republic of Bangladesh* (ICSID Case No. ARB/05/07) (*Saipem S.p.A v. the People's Republic of Bangladesh*)). Similar to soft law, it is deemed to detract from the treaty as a major source of international law, that sometimes does not correspond to the interests of host states and moreover may threaten their sovereignty.

## 2. Implementation of International Investment Law in a National Legal System

As it was shown, the current system of legal regulation of transnational investment relations includes numerous rules of law, which are contained in various sources and differ from each other by their legal nature and effect. In particular, some of them arise on the international level by the conclusion of multilateral and bilateral treaties between states, and thus belong to the system of international law. Others are created by international organizations, business, and arbitration institutions. Furthermore, the key source of investment law continues to be the domestic law of a host state.

In spite of their different origin and legal power, it is thought that they all regulate transnational investment relationships within a national legal system. It is deemed the only legal system, which is capable to embrace different rules (treaties, foreign law, customs, etc.) all together and thus to ensure the proper exercise of legal rights and duties of physical and juridical persons, including the recognition and compulsory execution of foreign judicial and arbitral awards. In contrast, the international legal system is designed only for intergovernmental cooperation among states and it cannot effectively implement rules made for private persons.

In other words, transnational investment relations between a private person, on the one hand, and a host state, on the other hand, should not be treated intergovernmental and consequently subject to regulation within the international legal system. Otherwise they would be governed just international law. However, as it is stated in Article 42(1) of the Washington Convention, the applicable law to transnational investment disputes is primarily indicated as the domestic law of a host state.

In addition, it is to say that states, including the Russian Federation, may enter into contractual and other civil relations with individuals and legal entities. But in this case they act as subjects of private law, rather than international public law. For example, in conformity with Article 124 (1) of the Civil Code of the Russian Federation *'the Russian Federation, the subjects of the Russian Federation: republics, territories, regions, cities of federal importance, the autonomous oblast, autonomous districts, and also the urban and rural settlements and the other municipalities shall participate in the relationships, regulated by the civil legislation, on equal terms with the other participants of these relationships – citizens and legal entities* (Civil Code of the Russian Federation 1994).

That is why it is argued that any attempts to determine legal rights and obligations of states and foreign investors as subjects of public international law within an international legal relationship have never been successful yet. In particular, it concerns ICC Guidelines for International Investments (2012 version), OECD Guidelines for Multinational Enterprises (2000). Although they contain a broad list of rights and duties of foreign investors and host states, but do not provide the proper legal mechanism of their implementation, including any remedies in case of their violations. All of them are thought to be just declaratory and advisory in their nature and incapable to become effective norms of international investment law without their application in a national legal system. In other words, only both international and national law is able to govern transnational investment, non-intergovernmental in their nature, relations.

The need to differ inter-state from private legal relations is emphasized by international litigation and arbitration practice. For example, yet in the last century the International Court of Justice in *Anglo-Iranian Oil Company Anglo-Iranian Oil Co. Case* distinguished between the concession agreement concluded between the Anglo-Iranian company and the Government of Iran, and the Agreement between Iran and the UK and found that the UK is not a party to the concession agreement, and as a result it cannot require the implementation of Iran's obligations stipulated by the concession contract to the company. On this basis the International Court of Justice admitted itself incompetent to settle the dispute.

In *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan* (ICSID Case No. ARB/01/13) ICSID tribunal also made a distinction between the violation of a treaty and a contract and noted that a state may violate a treaty without any breach of a contract and *vice versa*. Under the interpretation of Article 11 of the bilateral treaty, it concluded that the article does not raise the breach of a contract to the violation of a treaty, although, in principle, it does not mean that a state cannot provide expressly for such a provision in the contract ('umbrella clause', 'elevator clause', 'mirror clause'). As a result, ICSID tribunal stated its jurisdiction over disputes arising out of a treaty, and the lack of its jurisdiction over investment disputes involving the breach of the contract.

### 3. Types of Investment Disputes

At present there is no precise legal definition of an investment dispute. As it follows from Article 25(1) of the Washington Convention, it is *'any legal dispute arising directly out of an investment'* (Convention on Settlement of Investment Disputes between States and Nationals of Other States 1965). Such broad understanding, especially without the unified and accurate definition of investment, leads to the conclusion that investment disputes can be diverse.

Depending on a legal system, international or national, within which the legal rights of the participants are protected, it is suggested to distinguish two types of investment disputes:

- (1) investment disputes between a host state and a home state or an international organization, which arise out of international public legal relations, have intergovernmental character in their nature and are settled according to the rules of public international law by international courts, first of all, the International Court of Justice, and arbitrations in the international legal system. For example, according to Article 64 of the Washington Convention *'any dispute arising between Contracting States concerning*

*the interpretation or application of this Convention which is not settled by negotiation shall be referred to the International Court of Justice by the application of any party to such dispute, unless the states concerned agree to another method of settlement’.*

This kind of investment disputes can also arise in case of diplomatic protection of investors by their home state, which is based on the fact that the harm to its citizens and legal entities is an injury to the state. It is implemented by a home state (Schreuer 2001) for its political discretion within the international, rather than a national, legal system usually when its citizens and legal entities are not able to protect their rights and interests in the courts of a host state. It can take place when the host state violates the rules of public international law, particularly in such cases as: (a) the adoption of legislation, which discriminates against foreign citizens and legal entities; (b) the expropriation without a compensation; (c) the violation of the provisions of a bilateral treaty (Peter 1995).

There is no doubt that such investment disputes are originally based on private law disputes, which have arisen before between a foreign investor and a host state. The latter ones may be settled in international commercial arbitrations and should not be removed to the international legal system. Such emphasis is made in the Washington Convention, Article 27(1) of which expressly provides that *‘no Contracting State shall give diplomatic protection, or bring an international claim, in respect of a dispute which one of its nationals and another Contracting State shall have consented to submit or shall have submitted to arbitration under this Convention, unless such other Contracting State shall have failed to abide by and comply with the award rendered in such dispute’*;

- (2) investment disputes between a foreign investor and another physical or legal person or a host state, which arise out of a contract or non-contractual legal relation, and to be settled according to the rules of international and national law by state’s courts and international commercial arbitrations in a national legal system. The responsibility of participants of such investment disputes, a host state or a foreign investor, which is expressed in the obligation to pay damages (compensation – in terms of most treaties), is deemed to be private (civil) in general. The reason for this is that neither the involvement of the parties into international commercial arbitration nor the application of international law as the legal ground for such a compensation (which is always invoked in accordance with applicable national law) changes the private law nature of the investment disputes concerned.

However, it is possible to find a different point of view in legal literature, which justifies imposing international responsibility on a host state before a foreign investor. For example, K. Hober believes that draft Articles on Responsibility of States for Internationally Wrongful Acts, prepared by UNCITRAL, in Article 1 covers all the international obligations of states, including before private entities (Hober 2007). Meanwhile, such an approach is usually not supported by most Russian scholars who point out that the document is intended to regulate inter-state, rather than private, relationships (Voznesenskaya 2011:295). It is also hard to agree with the existence of so-called diagonal relationships (Hofmann 2012), the design of which is supposed to lead to further confusion, but not the division of inter-state and private legal relations. In this regard a famous Soviet scholar in the sphere of private international law L.A. Lunts wrote that *‘the doctrine, according to which an agreement between an individual or foreign company and a state is derived from the sphere of civil law and put into public international law, is based on the thesis on the possibility for a private organization and an individual to be a subject of international legal relations – the thesis, which is in direct contradiction with the principle of state sovereignty’* (Bogatyrev 1992: 76).

#### **4. Civil Responsibility of a Host State Before a Foreign Investor**

From the first sight, the civil responsibility of a host state before a foreign investor can arise in case of a breach of a contract between them. National law of any state usually provides for a lot of remedies to the investor, including to claim damages (Civil Code of the Russian Federation 1994).

Meanwhile, the civil responsibility of a state before a private person can be also related to the non-contractual infliction of damage to the foreign investor as a result of illegal actions of the state’s bodies and their officials. They may violate the rules of both international and national law and include the adoption of a normative or individual act of a state or municipal body as well as the commitment of another action that violates the provisions of a treaty or an act of national legislation (in particular, on most-favored nation treatment, compensation in case of expropriation). For example, in *AMCO Asia Corporation, Pan American Development Limited and PT AMCO Indonesia v. the Republic of Indonesia* (ICSID Case No. ARB/81/1) the actions of Indonesia expressed in the non-performance of necessary measures to protect foreign investors against unlawful seizure of their property by military troops were found inconsistent with Indonesia’s international obligations.

It is deemed that such a violation (of a treaty in case of the absence of a contract) be considered as a *delict* and entail the application of civil responsibility to be imposed upon the host state according to, first of all, the national

law of the host state on torts. For example, according to Articles 16 of the Civil Code of the Russian Federation 'the losses, inflicted upon a citizen or a legal entity as a result of illegal actions or inactions of state and municipal bodies or their officials, including the issue of a legal act of the state or municipal body inconsistent to the law or another legal act, shall be compensated by the Russian Federation, the appropriate subject of the Russian Federation, or municipality' (Civil Code of the Russian Federation 1994).

Moreover, unlike the national legislation, the civil responsibility of the host state as a whole may be admitted in case of illegal actions of regional and municipal authorities and their officials. Such an approach is assumed to be put into the framework of the Washington Convention and then to be confirmed by ICSID practice. For example, in *Compañía de Aguas del Aconquija S.A. & Compagnie Générale des Eaux v. Argentine Republic* (ICSID Case No ARB/97/3) *Compañía de Aguas del Aconquija S.A.*, which is a subsidiary of the French company *Compagnie Générale des Eaux*, and the Argentine province of Tucumán concluded a concession contract in 1995. After some time, the governor and other officials of the province committed acts that impeded the implementation of the contract. In particular, they adopted legal acts, which required the company to provide certain categories of citizens with communal services at a reduced rate (toll-free) and allowed those citizens not pay the bills submitted by the company for the services rendered. ICSID tribunal concluded that although the Argentine government in fact was not a party of the contract, under the rules of international law, the actions of regional authorities in a federal state equal to the actions of the central government. Such a conclusion was also made in *Metalclad Corporation v. United Mexican States* (ICSID Case No ARB (AF)/97/1), in which the actions of the Mexican municipality Guadalupe, which were aimed to challenge the validity of the concluded agreement on the operation of the burial and to impose a ban on its use, were found violating the provisions of NAFTA (in the terms of expropriation) from Mexico.

The assignment of the civil responsibility on the whole state seems to have great practical importance to foreign investors. The matter is that in investment disputes it is always required to determine, to which level of a government (federal, regional or municipal) a guilty body or a person belongs. Sometimes it is hard to do that because of the vague distribution of powers among different levels of governments, that exists, for example, in the Russian Federation. Firstly, there are a lot of laws adopted (Federal Law of 6 October 1999 No 184-FZ 'On the General Principles of the Organization of Legislative (Representative) and Executive Bodies of State Power of the Subjects of the Russian Federation', Federal Law of 6 October 2003 No 131-FZ 'On the General Principles of the Organization of Local Government in the Russian Federation', etc.), which need to be analyzed. Secondly, according to them governmental bodies are entitled to transfer their powers to others. Thirdly, a state or municipal body or institution is usually admitted as a legal person so that it is sometimes not clear if a particular claim should be addressed to a public law entity (the Russian Federation, a subject of the Russian Federation or a municipality) or just a governmental body (institution) of the public law entity as a separate legal person.

## Conclusions

The legal regulation of transnational investment relations, including the responsibility of host states and foreign investors before each other, is performed according to a lot of rules of law, which are contained in various sources and differ from each other by their legal nature and effect, but within a domestic legal system capable to ensure the proper implementation of civil and other legal rights and obligations of the parties concerned. It is argued that the involvement of foreign investors and host states in international arbitration, including ICSID, and the application of international law (along with national law) as a legal ground for the payment of compensation, do not change the nature of the existing legal relationship from private to international (intergovernmental) one.

The responsibility of the host state to the foreign investor also remains in the private, rather than international public law sphere. It is expressed in the state's obligation to pay compensation for damage inflicted to the foreign investor and awarded by state courts or international commercial arbitrations, including ICSID, in case of a contractual or non-contractual violation of rules of private law, embodied in an investment treaty, legislation, custom, etc.

As investment treaties can be a legal ground for civil (private) responsibility of host states before foreign investors, it is extremely important to detail their provisions in themselves or national legislation. States should not stand aside from the present process of making rules of investment law by non-state actors. This situation detracts from the treaty as a major source of international law, sometimes does not correspond to the interests of host states and moreover may threaten their sovereignty. As a result the role of treaties in the legal regulation of foreign investments has to be raised. It would limit the present unjustifiably broad application of soft law, usages, and arbitration practice without the due consent of the parties of an investment dispute by ICSID and other international commercial arbitrations.

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