STATE CONTRACTS IN THE CONTEXT OF GLOBALIZATION

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Globalization is the general trend today. It is a great and irresistible trend. As such globalization has successfully changed the attitudes of the people, forced members of the international community to reshape their policies toward economic development, foreign investment as well as administration of their internal affairs. Many matters that were regarded as purely domestic or internal affairs in the past now have been given international dimensions. Another characteristic of the globalized world is that every country is highly dependent upon others, regardless whether they are rich or poor, developed or less developed countries. This is more so with regard to economic development. Having said that members in the globalized international community are highly interdependent does not mean that all countries are equally independent of others or to the same extent, as different states are in different stages of economic development and has its own comparative advantages.

In the highly globalized world, transnational corporations play a more and more important role in particular in the development of natural resources by the developing countries and government procurement in the construction of large projects. It is in this connection that State contracts still play an important part today. Traditionally, State contracts refer to investment contracts signed by a State and foreign investors. Most of these contracts take the form of license or concession agreements and are related to the host country authorizing foreign investors to explore natural resources such as oil, coal and minerals. State contracts are sometimes called Economic Development Contracts. The term emphasizes that these contracts are related to the economic development of the host country and that the parties to the contracts are State government and foreign private investors. Recently, some academics have broadened the scope of State contracts to embrace the long-term energy exploitation agreements between foreign investors and the State companies owned or controlled by the State. This is a wide definition of the concept of State contracts indicates the characteristics thereof: large amount of investment capital is involved; long duration of contract which varies from 30 to 50 years; the host country promises not to pass legislation, administrative regulations or take other government actions during the validity of the contracts, which may have adverse effect on

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the foreign investors, so as to safeguard the contractual rights of the foreign investors. With regard to applicable law, some earlier contracts stipulated to be either the general principles of law or the common provisions of the laws of the host country and international law. In return, foreign investors promised to invest in the host country. Some contracts also included processing and business management in connection with exploitation of oil and minerals. The reason for State contracts to receive a lot of attention from the international community is that many cases of nationalization and expropriation in the mid-twentieth century were related to State contracts. Another reason is that, up till now, the international community has not yet reached consensus on the basic theoretical issues relating to State contracts. This article is to discuss and analyze the nature, characteristics and terms of State contract, the applicable law and other issues in connection with State contracts.

Nature of State Contracts

Unlike private contracts, State contracts have the following in common: (1) the subject matter has a broad coverage, which not only includes individual sale and purchase transactions, but also includes transfer of technology to the host country; (2) the long duration of contract requires close cooperation among the parties as well as the acceptance of extensive responsibilities by the investors; (3) the parties emphasize their contractual obligation so as to strike a balance between the goal of the public interests of the sovereign state and the profitability pursued by the private investors; and (4) most State contracts have implied terms so as to safeguard the interests of the investors from the changes of laws and policies of the host country.[1] If State contract is not a normal investment contract, then what is the nature of such contracts? The importance of the nature of State contract lies in the direct intervention of the host country through its rights to amend and abrogate the contract.

The famous dictum of 1929 judgment of the Permanent International Court of Justice which is regarded as the authoritative pronouncement of the nature of State contracts reads: " Any contract which is not a contract between States in their capacity as subjects of international law is based on the municipal law of some country. The question as to what this law is forms the subject of that branch of law which is at the present day usually described as private international law or the theory of conflict of laws. "[2] In fact, this dictum is not free from doubt. For instance, it is not clear whether the statement that "every contract... is based on the municipal law of some country" means the capacity of the parties to contract or the applicable law governing the contracts. This is

1 See the arbitral award of Texaco Overseas Petroleum Company/ California Asiatic Oil Company and the Government of the Libyan Arab Republic) ("Texaco") 17 I.L.M. 16-17 (1978).

2 The Case Concerning Various Serbian Loans Issued in France 1 P.C.I.J. No. 20, at Vol 1, p41.

the precise reason why Professor Dupuy held in the Texaco case that contracts between States and private persons of foreign nationality could be subjected to the law of a truly international character, because the above award of the Permanent International Court of Justice also includes the words: "the rules may be common to several States and may even be established by international conventions or customs, and in the latter case, may possess the character of true international law".[3]

One of the tests to distinguish State contracts from private contracts is whether the contracting parties are of equal bargaining power and whether one of the parties has the public power and obligations of a sovereign state. This is because only sovereign states have the power to legislate and the obligations to manage its natural resources. From an international perspective, the host country should also enjoy the right of immunity. Foreign investors do not have these powers and thus are in a comparatively disadvantageous position. To address this imbalance, some advocates that State contracts should be governed by international law.

This argument however only reflects a partial and incomplete picture of the nature of State contracts. In practice, many transnational corporations have the manpower, resources and negotiation skills comparable, if not better, to most of the developing host countries. They are now even in a more favourable negotiating position as most countries are competing for foreign investment by granting preferential policies and measures. Needless to say, under the circumstance, it is during the negotiation stage that foreign investors, including transnational corporations can demonstrate their strongest position. This is also the time when foreign investors can gain the most favourable contractual benefits. The negotiating power of foreign investors weakens with more and more capital being invested. To maximize their profits, most investors demand to incorporate all the terms agreed upon at the pre-investment stage into the contract with the host country. The disparity in the status of the contracting parties naturally leads to divergence of demand and expectation of the contract. Foreign investors hope that the contract can be complete and that the terms thereof will not be unchanged during the life of the contract. However, the host country hopes to preserve a certain degree of flexibility so as to facilitate the amendment of the contracts when necessary. This reflects exactly the conflict of interests between the contracting parties of State contracts.

The objective of transnational corporations is obviously maximization of profits. The main driving force of foreign investment is therefore the immense profits derived therefrom. By making investments, transnational corporations also play a role in promoting the economic development of the host country.

3 See the award of Texaco case by R.J. Dupuy.

Some critics pointed out that it was unrealistic to regard foreign investment by transnational corporations as pure assistance to the economic development of the host country as their aim of investment was the potential profits: "The argument based on the view that they bring benefits to the developing states only shows the paucity of justifications possessed by international lawyers, all of whom, of course, will claim a high degree of rectitude, scholarship and impartiality, in formulating theories to advance the cause of foreign investors belonging to their states."[4] It goes without saying, this view only considered the motive of transnational corporations in foreign investments. In addition to the motive, it is necessary to consider the risks involved and whether the host country can provide adequate protection before embarking on an investment venture. In this regard, Fatourso said, "In some cases... investors may be willing to take the risk of a future worsening of investment conditions, especially when they are reasonably confident of their ability to defend effectively their own interests or when the expected profits are high enough to warrant taking the risk... But in other cases, and in particular with respect to those industries whose establishment is sought by capital-importing states... some assurance as to the future is needed. The investor must be made to believe that there is little or no possibility that an unfavourable legal situation will be created at a later date...In the case of most underdeveloped countries today, however, it is impossible to predict with confidence that conditions of stability and security will exist during the period of dynamic change ahead. Thus arises the need for legal guarantee to be given by the State or states concerned to foreign investor... Foreign investors have to be assured that they will receive, both today and in the future, a definite legal treatment, specified in the relevant legal instruments, and that consequently they need not fear any major changes in local legal or political conditions that would be unfavourable to their interests"[5]

Most of the State contracts are long term agreements which regulate the relationship between the host country and foreign investment companies at various stages, including the exploitation of natural resources, sale of goods and other financial arrangements and that some host countries, especially developing countries, regard conclusion of such contracts as part of their public policy, that is they regard such contracts as part of its economic development strategy. These transactions hence constitute the framework for joint investment in public infrastructure. Under this framework, the government and foreign investors cooperate in the development of public resources which have strategic value and other related important public interests. The host countries which

4 M. Sornarajah, *The International Law on Foreign Investment*, Cambridge University Press, Cambridge, 1994, p342.

5 Revere Copper and Brass, *Incorporated Overseas Private Investment Corporation, American Arbitration Association* ("Revere Copper Case"), 17 I.L.M. 1337 (1978).

are developing countries regard such activities as being regulated by public law as opposed to private contracts. Thus, the traditional framework for regulating private commercial activities and the rules to regulate the movement of goods in markets are inapplicable to such investment contracts.[6] In other words, the host countries are in fact exercising both contractual and public powers (i.e. the exercise of sovereign power) when performing contractual obligations. Hence, the host countries should have the power to amend or abrogate the contracts unilaterally.

Those who support the view that the host countries have the power to re-negotiate and amend State contracts believe that "instead of a contract in the traditional sense, an investment agreement could be regarded as no more than a broad framework in which the government and the transnational corporation declare their basic commitment to a particular undertaking or project, but a framework which admits of a continuous process of revision and redefinition of their relations when circumstances require.... In short, a long-term transnational agreement can only provide a basis for a viable and enduring relationship between a host government and a transnational corporation ..... rather than a body of fixed rights and obligations impervious to political, economic and social changes."[7] The former Secretary General of the International Centre for Settlement of Investment Disputes (ICSID) of the World Bank pointed out that "The starting point is the contract and in our context this means a long-term contract. Whatever might have been thought in the past, it is now common ground that unequal contracts are not viable. However, it may well happen over the life of an investment that what was fair and reasonable and equitable at the beginning may no longer be so in the light of changed circumstances. In such a case, revision or renegotiation may be called for. Many long-term agreements have in fact been revised in favour of host countries, sometimes as a result of voluntary renegotiation, in other cases by unilateral government action which was in the end accepted by the investor." [8] This reflects the realities of the international community. Many concession agreements are signed when the host countries could not deal with their own affairs independently. Thus, once these countries gained independence and sovereignty, they started to demand amendment of the concession agreements. A case in point was the *Kuwait* v. *American Independent Oil Co* ("Aminoil").[9] Aminoil was an American Company incorporated in 1947 in the State of Delaware with the object of exploring, producing, refining and selling

6 K.B. Asante, *"Stability of Contractual Relations in the Transnational Investment Process"* 28 Int'l & Comp. L. Q. 401 (1979).

7 Ibid, p 418.

8 Annual remarks to the Administrative Council, Centre for the Settlement of Investment Disputes 1980; Annual Meeting, Annex 2, 2 October 1980, p. 3.

9 Arbitration Award of *Kuwait* v. *American Independent* Oil Co. 21 ILM. 976 (1982).

petroleum, natural gas and other hydrocarbons. On 26 June 1948, Aminoil was granted a Concession by the British Government for the exploration and exploitation of petroleum and natural gas in what was then called the Kuwait "Neutral Zone". Kuwait was then a British protectorate. Later, Kuwait and Saudi Arabia concluded a Treaty by which they shared the Neutral Zone, known as the "Divided Zone". Aminoil's Concession was situated in the Kuwait side of the Divided Zone. Kuwait declared independent in 1961 and on 11 November 1962, the Constitution of Kuwait was promulgated, which read: all of the natural wealth and resources are the property of the State. Any concession for the exploitation of a natural resource or of a public utility shall be granted only by law and for a determinate period.

After Kuwait gained independence, it immediately started negotiations with the Aminoil about the concession agreement and reached agreements respectively in 1961, 1971 and 1972, requiring, inter alia, the increase in tax obligations of the latter. One of the reasons for the Kuwait Government to amend the concession agreement with Aminoil was that the original agreement was signed when Kuwait was a British protectorate, thus reflected a strong flavour of colonialism.[10]

One of the legal justifications for the host countries to amend concession agreement is the change of circumstances. The former Secretary General of the ICSID also supports the argument that a host country has such a right. He said, "I have expressed the view that long-term investment agreement should recognise the possibility of changing circumstances, that they should provide for renegotiation at the initiative of either the host country or the investor, and that they should seek to establish criteria which will permit a determination whether the change in circumstances has been such as to upset the contractual equilibrium. I am glad to say that the initial resistance on the part of investors to such renegotiation clauses is gradually disappearing."[11] This view is similar to that of the UN Centre on Transnational Corporations. The Draft Code of Conduct on Transnational Corporations states that contracts between governments and transnational corporations should be negotiated and implemented in good faith. In such contracts or agreements, especially long-term ones, renew or re-negotiation clauses should normally be included. In the absence of such clauses and where there has been a fundamental change of the circumstances on which the contract was based, transnational corporations, acting in good faith, should cooperate with host governments for the review or re-negotiation of such contract.[12] Overall, both the former Secretary General of ICSID and UN Centre on Transnational Corporations were of the view that

10 See the Defence of Kuwait Government in *Kuwait* v. *American Independent Oil Co.*

11 Annual remarks to the Administrative Council, Centre for the Settlement of Investment Disputes 1980; Annual Meeting, Annex 2, 2 October 1980, p. 3.

12 See Article 12 of UN Draft Code of Conduct on Transnational Corporations, Feb 1, 1988.

sovereign states had the power to choose their economic system free from intervention by other States.[13]

In practice, both developed and developing countries have relied on the principle of state sovereignty, especially the principle of sovereignty over natural resources, to abrogate or amend unilaterally state contracts. For instance, before the Revere Cooper Case was submitted to arbitration, the Jamaica Government expressed that it was necessary to re-negotiate with the transnational corporations regarding the original contracts because it was both a sovereign right and an obligation toward its citizens. Compared with the principle of inviolability of State contracts, the implementation of the sovereign power as sovereign states are much more important.[14]

Although western scholars always criticize the practice in State contracts by the developing countries, developed countries like Britain and Norway also employed the principle of sovereignty to unilaterally amend their agreements with private investors for the exploration and exploitation of oil in the North Sea. In these cases, the private investors suffered various degrees of losses. In the Norway cases, the Philip Oil Company which suffered adverse effect appealed to the High Court of Norway. The main arguments of the Philip Company included: the acts done by the Norwegian government constituted a breach of contract, a breach of administrative rules and the principle that laws did not have retrospective effect, thus its action were invalid. Ultimately, the High Court of Norway held in favor of the Philip Company and the Norwegian government was held liable to pay US$18,200,000 compensation to the Philip Company.

To a large extent, the debate on the nature of State contracts involves ideological issues. It is submitted that State contracts are different from international treaties because one of the parties to the contract is not a country or international organization, thus the laws applicable to international treaties and agreements do not necessarily apply to State contracts. Secondly, State contracts are not private contracts in the normal sense as they involve a State and that the signing and implementation of the contracts are related to the economic development of a host country. Thirdly, the nature of State contracts must be considered separately from their applicable law. In many State contracts, the contracting parties choose the applicable law. Another reason for State contracts not to be international treaties or agreements is that most of them involve political and macro-economic issues, despite the fact that they are concerned with economic development of the host countries.

13 The International Court of Justice confirmed this principle in the *Nicaragua Case*. See I.C.J. Report (1986) at 186.

14 See Revere Copper Case.

State Contracts and Contract Law Principle

The essence of the nature of State contracts and the status of the parties thereto is whether state contracts can be amended. If the answer is "yes", the next question will be to what extent State contracts may be amended which will be followed by the question whether the principle of pacta sunt servanda applies to State contracts. There have been two opposite views to this question. The ruling of Aminoil's answer is negative. In that case, the Kuwaiti government pointed out that it was a well-established principle of international law that the State had permanent sovereignty over its natural resources[15] and accordingly State governments had no power to grant concession to foreign investors for the exploitation of natural resources. Those who support the positive view advocate for the inviolability of State contracts. The basis for this argument is that *pacta sunt servanda* is a general principle of law. Some academics argue that State contracts embrace the characteristics of both private and public law. This view is affected by the tradition of common law countries such as the United States and Britain where there is no distinction between private and public law.[16] It is also affected by the international arbitration practice such as the decision of the Sapphire case.[17] In those cases, the arbitration tribunal recognized that State contracts had the characteristics of public law.

With regard to whether concession agreements are contracts, there appears to be a consensus at international level. In the *Saudi Arabia* v. *Arabian American Oil Company*, it was pronounced that the concession agreement signed between sovereign state and foreign investors was based on the principle of sovereignty, according to which the State had legal power to grant concession to foreign investors and promised not to withdraw the concession before the expiration of the agreement. "When a sovereign state is exercising its sovereign power, there is nothing to prevent him from promising to grant concession to and never regret later."[18] Certainly, the fact that state contracts are manifestation of the principle of sovereignty is conditional, i.e. the signing of State contracts is not affected by other factors. In other words, the host country is free of foreign interference and independent in exercising the sovereign power.[19]

The practice of international arbitration shows that there is little dispute over the contractual nature of State contracts. "The writings of renowned

15 See *Aminoil case.*

16 Some academics regard the distinction between public and private law of the continental countries as an invention. See Geiger, *Unilateral Amendment of Economic Development Contracts* 23 Int'l & Comp. L.Q. 73 (1974).

17 *Sapphire International Petroleum Ltd* v. *National Iranian Oil Company* ("Sapphire case"), 35 ILR 136 (1967).

18 *Saudi Arabia* v. *Arabian American Oil Company* (Aramco) 27 ILR 117 (1958).

19 As mentioned before, the Kuwait Government, in its Defence, argued that when the Concession Agreement was signed, Kuwait was a protectorate of Britain, thus could not exercise its sovereign power independently. See Aminoil case.

academics of international law and the cases show that there is now no serious dispute over the contractual nature of concession contracts. Judges and international arbitrators do not need to show the contractual nature of concession contracts but merely declare that concession contracts have contractual characteristics. This trend is consistent with the practice among countries and international organizations on contracts. In the past, International legal documents compared concession agreements to contracts. Later, the discussion of the United Nations on 14th December 1962 regarding the 18903 Resolution on Permanent Sovereignty over Natural Resources, the contractual nature of concession agreements was not on the agenda, even the advocates of state sovereignty have not raised any question on the issue."[20] Professor Dupuy, the arbitrator of the Texaco case, said that "The Tribunal must consider this question in the light of the general principles of law and the teachings of comparative law: a contract is defined as an agreement of one or several wills for the purpose of creating legal obligations. It appears therefore that, from a formal point of view and prima facie, the Deeds of Concession in dispute were of a contractual nature since they expressed an agreement of the wills of the conceding State and of the concession holders. Furthermore, the contractual nature of the Deeds of Concession corresponds to the standard accepted both by international practice and by international theory."[21] "International practice" referred to by Dupuy obviously includes the ICJ judgment on British Iraq Oil Company case and the fact that many judges and arbitrators regard concession agreements as contracts in international arbitration.[22]

Recently, some suggest that the State, as a public authority, has the responsibility to amend or abrogate contracts with private companies when necessary. For example, for the sake of the safety and welfare of the society, it may be necessary for the State to implement corresponding measures. When implementing these measures, personal interests, including those of the private investors, will be subordinated to public interests, so that contracts between the government and private companies may be amended or abrogated unilaterally. This commonly referred to as lawful amendment and abrogation. To put it the other way round, it would be that if the host country acts not for the public interests nor in exercising public power or the measures concerned are discriminatory, the related amendment or abrogation will be illegal. Applying this principle to the principle of sustainable development which is gaining international attention and becoming one of the mandatory rules of international law and international economic law, it is predictable that State has every reason to amend or refuse to implement the contracts it signed with private companies.

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20 M.Cohen Jonathan, *Les Concessions en Droit International Public*, these, 1966, p133-134.
21 Texaco case, p10.
22 1952 I.C.J. 111-112.

This is one of the consequences of globalization on State contracts.

Apart from the above examples, it is generally agreed that the state is bound by the principle of good faith in signing contracts with private companies. The basis for this argument is that the state has a dual personality of public authority and ordinary merchant. "The notion of permanent sovereignty can be completely reconciled with the conclusion by a State of agreements which leave to that State control of the activities of the other contracting party. As regards the question of permanent sovereignty, a well-known distinction should be made as to enjoyment and exercise. The State granting the concession retains the permanent enjoyment of its sovereign rights, it cannot be deprived of the right in any way whatsoever, the contract which it entered into with a private company cannot be viewed as an alienation of such sovereignty but as a limitation, partial and limited in time, of the exercise of sovereignty. Accordingly, the State retains, within the areas which it has reserved, authority over the operation conducted by the concession holder, and the continuance of the exercise of its sovereignty is manifested, for example, by the various obligations imposed on its contracting party, which is in particular subjected to fiscal obligations that express unquestionably the sovereignty of the contracting State."[23] The purpose of distinguishing the enjoyment from exercise of sovereign power is to illustrate that the granting of concession to foreign investors by a State is the exercise of sovereign power, and like bilateral treaties between countries, is a voluntary restriction of that power. Thus, they are both binding on the sovereign states and other contracting parties.

With regard to the contractual characteristics of State contracts, there is no dispute. However, opinions differ as to how to distinguish and safeguard the effectiveness of State contracts. Apart from internationalization of State contracts, some suggest that State contracts should be treated as administrative contracts within the public law regime, or apply the administrative law principles to State contracts. According to this view, under all the main legal systems, State governments and organizations may enter into contracts with private parties, which contracts are subject to public interests, i.e., the relevant state governments or governmental organizations may amend or abrogate contracts based on public need. Those who hold the opposite view claim that administrative contracts are the products of the French law without any special meaning. Professor Dupuy, for instance, stated that although Libyan law had inherited the French tradition, the concession agreement in question did not have all the characteristics of administrative contracts.[24] However, a few years

23 See Texaco case, at p26.

24 The reasoning of Dupuy is that: administrative contract is essentially unequal and enables the State legal entity which has executed it to amend unilaterally the provisions thereof, and even to decide in certain cases - subject to the requirements of public interest - that it shall be abrogated. Accordingly,

ago, a French lawyer pointed out that the abrogation of State contracts based on public interest was a common characteristic of all the legal systems.[25] It is fair to say that at the moment the mainstream view does not regard State contracts as administrative contracts. If the conclusion by Audit is correct, the principle that the State can abrogate State contracts based on public interests, *pacta sunt servanda* and change in circumstances are all general principles of international law. In dispute settlement concerning State contracts, the choice of applying any particular principle by the courts or arbitral tribunals will depend on with whom the burden of proof rests. In other words, the one who proposes applying the principle may later find that the application of the general principle of law is not favourable to him. Besides, if there is evidence to prove that any party has abused its power, political, economic or otherwise, the validity of the contract itself may have problems. Under these circumstances, it is a logical and legal step to amended or abrogated the contract. Needless to say, deceit, duress or corruption will lead to the abrogation of contracts in almost all legal systems. This is more so with the ever-increasing integration of legal concepts, values and principles in this globalized world.

Internationalization of State Contracts and Compensation

Internationalization of State contracts was first advocated by western academics. According to their view, State contracts are transnational in nature and as one of the parties is a sovereign state, they have the elements of treaties in international law and therefore should be treated as international contracts. Internationalization of State contracts in effect is to take such contracts out of the jurisdiction of domestic law. This proposition is contrary to the traditional international law principle. As mentioned earlier, the Permanent International Court of Justice pointed out in the Serbian and Brazilian Loans Case, the contracts signed between a State and private persons should be governed by domestic law as stipulated in private international law. This principle was also recognized in the practice of some developed countries. For instance, in *Kahler* v. *Midland Bank*, the British Court of Appeal held that where the contracts between a State and a foreign private company stipulated that the governing law was that of the host country, then the law of the host country not only gave validity to the contract, but also gave the State the power to "amend or abrogate their contractual obligations".[26] The basis of this principle is that every State

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administrative contract has the following three components: (1) for the management or the exploitation of a public service; (2) being entered into by administrative authority; (3) confering upon the administrative authority rights and powers which are not usually found in a civil contract, such as the power to amend unilaterally or abrogate unilaterally the contract if the public interest so requires. See Texaco case, p19.

25 B. Audit, *Transnational Arbitration and State Contracts*, Dordrecht: Martinus Nijhoff, 1988.

26 *Kahler* v. *Midland Bank*, AC 56 (1950).

has the power to contract with another State or private company. It has been recognized in the teachings of international law, international cases such as the Wimbledon case of the Permanent International Court of Justice. In Wimbledon case, the Permanent International Court of Justice emphasized that signing treaties was a manifestation, not a negation of sovereignty. Accordingly, the economic development contracts signed between a State and private companies are not negation but exercise of sovereignty.

In Texaco, however, Dupuy pointed out that the judgement of the Serbian and Brazilian Loans was no longer applicable because of new developments in international law.[27] He said that "This tends more and more to delocalize the contract, or if one prefers, to sever its automatic connections to some municipal law: so much so that today when the municipal law of a given State, and particularly the municipal law of the contracting State, governs the contract, it is by virtue of the agreement between the parties and no longer by a privileged and so to speak mechanical application of the municipal law."[28] Moreover, according to Dupuy, State contracts were not necessarily governed by domestic law of the host country as such contracts had been internationalized either by reference to the settlement of disputes by general principles of law or by the character of the contract itself. In the latter respect, Dupuy referred to the special features of State contracts including the broad subject matter involved, the introduction into the developing countries of foreign investment and technical assistance, the importance in the economic development of the host countries, the long duration which implied "close cooperation between the State and the contracting party" and required "permanent installations as well as the acceptance of exclusive responsibilities by the investor" and the close association of the foreign contractor "with the realization of the economic and social progress of the host country". Because of the required cooperation between the contracting parties and "the magnitude of the investments to which it agreed", the contractual nature of the legal relations was "intended to bring about an equilibrium between the goal of the general interest sought by such relation and the profitability which was necessary for the pursuit of the task entrusted to the private enterprise."[29] However, when one considers the applicability of the general principle of law to State contracts, or equilibrium of the interests of the parties concerned, the contractual behaviour of the host country may in no way be considered as a negation of sovereignty, nor may it be regarded as negation of the right empowered by private international law to choose the governing law. From this perspective, the argument of Dupuy is not without doubt nor is sufficient.

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27 *Serbian and Brazilian Loans Case*, 1 P.C.I.J. No. 20 (1929) p41.

28 *Texaco case*, at p12.

29 *Revere Copper case*, at p1334

The purpose of the internationalization of State contracts is to put the host country and private investors on the same footing. The effect is that where there is a dispute between the foreign investors or their home country and the host country, it can be resolved according to the principles of international law. This is stated clearly by Mann who advocates for the internationalization of State contracts, "Under normal circumstances, State contracts are governed by the laws of the particular country, there is another formula suggested a few years ago. According to this formula, the contracts between a State and foreign private persons can be internationalized, that is putting contracts under another legal system i.e. public international law. It does not mean that State contracts shall be governed by public international law in the same way as treaties or other transactions between countries. What we are saying is that contracting party of State contracts can choose public international law as the governing law of contract."[30] Why should one choose public international law as the governing law? It is because one of the characteristics of the current international relations, especially that of the international economic relations, is that it is becoming more common for States to involve directly in commercial activities which are originally carried out by private persons or companies. Under these circumstances, "the public international law regime regulating the interests of private persons sometimes afford greater protection than the private international law. "[31] The basis of the argument is that private enterprises such as transnational corporations also enjoy certain legal personality in international commercial activities.[32]

An extreme example of internationalization of State contracts is the Revere Copper case in which the arbitration tribunal held that the nature of State contracts required such contracts to be governed by transnational law.[33] The basis of the argument was that "it was incontestable that these contracts were international contracts, both in the economic sense because they involved the interests of international trade and in the strict legal sense because they included factors connecting them to different States, an international contract having been recently defined as being 'that contract whose elements are not all located in the same territory'..."[34] Besides, State contracts were agreements which fell "within the international legal order since the contracting State agreed to submit the agreement not to the exclusive, and unlimited in time, application of its municipal law, but to rules falling at least in part within the framework of international law or of general principles of law."[35] Dupuy's argument was

30 F.A. Mann, *A Theoretical Investigation of the Applicable Law of Contracts between State and Private Persons* Rev. Belge D.I. 1975, p564-565.

31 F.A. Mann, at 615.

32 For discussion on the legal identity of transnational corporations, see Guiguo Wang, "New Neo-Confucianism: International Economic Law" 13 *Journal of Comparative Law* 299-334 (1999).

33 See *Revere Copper case.*

34 See *Texaco case*, at p11.

35 See *Texaco case*, at p23.

later adopted by other writers and in arbitration practices. It is now a standard statement of internationalization of State contracts. In practice, as early as in Armaco in 1958, the arbitration tribunal regarded concession agreement signed between the Saudi Arabian government and a private American company as having an international element. Having considered the status of the two parties, one being a State and the other a private company, the long duration of the concession agreement and the fact that it related to the exploitation of natural resources, the arbitration tribunal held that the concession agreement was an international contract.[36]

Internationalization of State contracts is also referred to as delocalization of State contracts. Whether it is called internationalization or delocalization of State contracts, the result is the same, that is privatization of the contracts between host countries and foreign private companies. The internationalization or delocalization of contracts has the effect of raising the status of foreign private investors to that of a State, at least with respect to the performance and breach of contract. It has therefore undoubtedly neglected the public law obligations of the State. Thus, even Dupuy, who was the strongest advocate of internationalization of State contracts, admitted that concession agreements were different from ordinary private contracts in certain respects. He pointed out that, unless the contract in question stated otherwise, the host country concerned should be regarded as having reserved its privileges and powers, i.e. the right to amend the contract.[37]

Some academics do not emphasize the internationalization of State contracts or compare State contracts with international treaties. Instead, they claim that the host countries unilateral amendment or abrogation of contracts constitute a breach of contract in international law, regardless of whether the governing law chosen is the law of the host country, the international law or the laws of other countries.[38] This view is, in fact, similar to that of the Digest of International Relations of the U.S., which states that: "any State which breaches the contracts signed with a foreigner shall be liable for breach of contract in accordance with the laws of the country concerned, but it does not mean that all the breaches of contract (regarding contracts with foreigners) committed by a State constitute a breach of international law". According to this statement, only when the breach of contract by the host country is discriminatory or is based on non-commercial considerations and the host country refuses to give compensation will the U.S. government consider using diplomatic means to assist. In order words, the U.S. recognizes the power of the host country to refuse to perform the State contracts, but the latter has an

36 See *Aramco case*.

37 See *Texaco case*, at p20.

38 R.Y. Jennings, *State Contracts in International Law* 37 Brit.Y.B. Int'l L. 156 (1961).

obligation to pay compensation. It does not mean that the U.S. government will intervene in every contractual dispute between a U.S. company and a foreign government. It is stated clearly in the Digest of International Law by Hackworth that, "Generally speaking the Department of State does not intervene in cases involving breaches of contract between a foreign state and a national of the United States in the absence of a showing of a denial of justice..... The practices of declining to intervene formally prior to a showing of denial of justice is based on the proposition that the Government of the United States is not a collection agency and cannot assume the role of endeavoring to enforce contractual undertakings freely entered into by its nationals with foreign states."[39] The view of the Digest of International Relations and Digest of International Law represent exactly the view of the United States and other developed countries in the 1950's. With the growing conflicts with the Eastern European countries like the former Soviet Union and other socialist countries, mass scale nationalization after the independence of the former colonies and greater participation of the State governments in commercial activities, the developed countries with the United States taking the lead began to abandon the principle of sovereignty and acts of State doctrine, and to adopt a restrictive approach. The advocate for internationalization of State contracts reflected this change in policy. The purpose is to enable the foreign investor's home country intervene directly into the contractual disputes between the foreign investor and the host country.

The reason why State contracts are related to nationalization is that, traditionally, nationalization was carried out in accordance with domestic laws of the nationalizing state. If State contracts are under the total control of the domestic laws of the host country, the nationalization or expropriation of the assets of foreign investors, whether a breach of contract or not, does not necessarily lead to international responsibilities of the host State. Strictly speaking, it is only when State contracts are regarded as having an international character, and the host country in question nationalizes the property of foreign investors disregarding its contractual obligations, could the State be held responsible for breach of contract in accordance with international law. In Texaco, Dupuy mentioned the relationship between nationalization and the international responsibility of the host State. He said that when the State and foreign investors signed economic development agreements, "the State has placed itself within the international legal order in order to guarantee its foreign contracting party a certain legal and economic status over a certain period of time. In consideration for this commitment, the partner is under an obligation to make a certain amount of investments in the country concerned and to explore and exploit at its own risk the petroleum resources which have been conceded

39 Hackworth, *Digest of International Law*, Washington D.C., 1943, Vol 5, p611.

to it. Thus, the decision of a State to take nationalizing measures constitutes the exercise of an internal legal jurisdiction but carried international consequences when such measures affect international legal relationships in which the nationalizing State is involved."[40] This conclusion is very similar to the principle emanated by the UN Resolution No. 1803 regarding permanent sovereignty over natural resources by the State adopted in 1962. According to the Resolution, a State cannot by reason of sovereignty refuse to perform its international obligations; a State cannot enact domestic laws or implement government measures to invalidate the rights of the other contracting party which has already performed the contract.

The International Law Commission also expressly stated that a State could negate its international responsibility based on domestic laws in its Third Report on State Responsibilities to the United Nations. The report reads: "the fact that some particular conduct conforms to the provisions of national law or is even expressly prescribed by those provisions does not make possible to deny its internationally wrong character when it constitutes a breach of an obligation established by international law...a state cannot plead the provisions (or deficiencies) of its constitution as a ground for the non-observance of its international obligation. It is indeed one of the great principles of international law, informing the whole system and applying to every branch of it."[41]

To recognize State contracts as binding on the contracting State, the State concerned must bear legal responsibility for breach of contract. In this respect, academics both supporting and opposing the State responsibility in relation to compensation agree that restituio in integrum is not the best mode of compensation for the breach of contractual obligations by the State. Even the strong advocates of restituio in integrum as a principle of international law agree that this principle is inapplicable to State contracts.[42] The sole arbitrator in Texaco, Professor Dupuy, stated on the one hand that restituio in integrum was a principle of contract law and, on the other hand, pointed out that it was very seldom in international arbitration practice to adopt this mode of compensation. The same conclusion was arrived in the *Libyan American Oil Company* v. *Libyan Government*. In that case, the arbitration tribunal ordered the Libyan government to restituio in integrum but at the same time pointed out that this remedy was not a normal means of compensation in international arbitration because the arbitration tribunal had no means to enforce the award against the host country.[43] Restituio in integrum is therefore not yet a common

40 See *Texaco case*, at p22.

41 Yearbook of the International Law Commission, 1971, Vol 2, p227.

42 *BP Exploration Co. Libya Ltd* v. *The Government of the Libyan Arab Republic*, 53 ILR,303 (1988).

43 *Libyan American Oil Company (LIAMCO)* v. *Government of the Libyan Arab Republic* (*LIAMCO case*) 20 ILM 1 (1981).

standard in international arbitration. Under these circumstances, monetary compensation is naturally a better choice.

Monetary compensation normally includes the market value and foreseeable profits of direct investment of foreign investors. It is always controversial as to what constitutes the market value. The foreseeable profits are much more difficult to determine. Foreseeable profits must have a certain degree of certainty and must have a direct relation with the contracts. In other words, the parties must prove that the breach committed by the host country has directly led to the non-realization of profits. From this perspective, the calculation of loss of profits must be reasonable. In *Libyan American Oil Company* v. *Libyan Government*, it was held that there was no conclusion as to whether the concession holder could obtain compensation for the loss of profits expected during the validity of the contract.[44] The arbitration tribunal used the judgment of the Asylum case to explain that it was the political factors which led to the failure of forming customary law in this area.[45] The tribunal held that the then international law and practice had not formed any principle on compensation. "In such confused state of international law, as is evident from the foregoing precedents and authoritative opinions and declarations, it appears clearly that there is no conclusive evidence of the existence of community or uniformity in principles between the domestic law of Libya and international law concerning the determination of compensation for nationalization in lieu of specific performance, and in particular concerning the problem whether or not all or part of the loss of profits (lucrum cessaus) should be included in that compensation in addition to the damage incurred (damnum energens)".[46]

International practice shows that the calculation of the amount of compensation should include consideration of the long duration of the contract in question and the expectation of the parties, so as to balance the rights and responsibilities, opportunities and risks. Besides, under normal circumstances, assessment of real assets should be calculated by accounting or taxation methods. The net book value is only applicable to recent investments, as the cost of such investments is close to the substitution cost. For earlier investments, other means of compensation should be adopted.[47]

The Forms of State Contracts

Like any other law, international law is also a two-edged sword. A principle, a regulation, a precedent of international law, may in certain point of

44 *LIAMCO case*, p144.

45 The International Court of Justice pointed out in the Asylum case that "The practice has been so much influenced by considerations of political expediency in various cases, that it is not possible to discern in all this any constant and uniform usage, accepted as law, with regard to the alleged rule." ICJ Reports , 1950, p3.

46 *LIAMCO case*, p149-150.

47 See *Aminoil Case*.

time be favourable to certain countries, individuals or companies. However, the lapse of time may render the same principle, regulation or precedent unfavourable to such countries, individuals or companies. The internationalization of State contracts is obviously unfavourable to the developing host countries. However, the same principle also affects the developed countries. As Judge Higgins of the International Court of Justice pointed out, in discussing the nationalization measures of Libyan Government, that in the case of breach of concession agreements and deprivation of property rights, the international arbitration practice tended to give the affected party the power to obtain compensation in international law; "such findings would undoubtedly command the sympathy of western national governments of oil companies. But as recent legislation in some of those western countries who are oil producing countries shows, techniques are now in place for avoiding the impact of these principles of international law. New mining rights in developing countries are entirely likely to follow the model offered by such western example."[48] The international practice confirms that the view of Judge Higgins is quite far sighted. In order to avoid unfavourable treatment in international dispute settlement, and having learned the experience from the developed countries, most modern State contracts on exploitation of natural resources do not take the form of concession agreements.[49] Besides, more and more countries treat foreign investment agreements as contracts governed by public law rather than private law. This situation is remarkable in Europe.[50]

Compared with earlier State contracts, nowadays, there is a marked change in the way State governments or government organizations participate in economic development contracts. Firstly, as an attempt to avoid the problem of governing law, many hosts which are developing countries began to cooperate with foreign investors through companies formed by the host governments. By doing so, the host government is in a supernatural position. Strictly speaking, the formation and enforcement of these contracts have to be approved, recognized and supported by the host government concerned. Besides, the way of investment and profits making by foreign investors have also changed concession agreements to cooperative ventures, division of products, service agreements and technological assistance agreements, etc.

Joint Ventures are also called joint shares companies. Under this arrangement, the host government may hold the shares directly or through State

48 R. Higgins, *The Taking of Property by the State: Recent Developments in International Law* Recueil des Cours, Vol 176, 1982, p314.

49 Certainly, the change in the mode of State contracts is directly related to the emphasis on sovereignty by the developing countries.

50 R.W. Bentham, *The International Legal Framework of Oil Exploration* in J. Rees and P. Odell (ed.), *The International Oil Industry, Basingstoke*: Macmillan Press, 1987, at p57.

enterprises, or stipulate in the laws the proportion of shares to be held by local enterprises. To safeguard the right of veto in the joint venture, many developing host countries prefer to hold more than 50% of the shares. This form is widely used in the exploitation of oil and natural resources ventures. It does not however mean that the host countries play a dominate role in the joint ventures as exploitation of natural resources normally involve a lot of technical issues and the host countries or local enterprises must rely on the experience and knowledge of the foreign investors. Under these circumstances, the foreign investors can play a key role in decision making of the joint ventures despite their minority shares.

Division of products is also a popular form of exploitation of natural resources ventures. In this respect, many countries adopt the Indonesian model, under which, transnational corporations are responsible for the provision of technology and expenses and take all the risks. The Indonesian government allowed foreign investors to take 40% of the products as payment for the annual expenses of the venture. In case the amount was insufficient, the difference must be transferred to the coming year. For the remaining 60%, Indonesian company had 65% while foreign investor had 35%. The foreign investor obtained full property rights to the oil when it started to be exported. The exploitation of oil agreement signed by Nigeria in 1973 basically adopted the Indonesian model, but it allowed the foreign investor to obtain property right to the oil when it first came out of the oil field. Besides, a good number of product division agreements stipulate that the host countries have the power of supervision over the foreign investment in question. The reason for the express provision of supervision by the host country is to avoid the arbitrary interpretation of the meaning of the agreement by international arbitration tribunals.[51]

At the present, there are a lot of similarities between service trade agreements and technological assistance agreements. Under a typical service and technology assistance agreement, the foreign company provides all the required capital, while its subsidiary provides all the technologies. The parent company will buy a certain quantity of oil or other products at a pre-determined price. The host country authorizes the foreign investor to be responsible for the international sales of all the products. The foreign investors have their investment paid back with the profits earned therefrom. In a pure technological assistance agreement, the foreign investors only provide technological assistance without the input of capital. In return, the host country may pay a lump sum to the foreign investors or allow the foreign company to purchase a certain amount of products at a pre-determined price.

51 For instance, in the Sapphire case, the arbitration tribunal held that the intervention of the host country constituted a breach of contract.

The change in the form of State enterprise is directly related to the practice of the international community, and is a response to the dispute resolution concerning State contracts in the last 50 years, especially through international arbitration. This is also reflected in multilateral treaties on exploitation of energy resources, such as the Energy Charter Treaty.

Article 10(1) of the Energy Charter Treaty states that each contracting party shall observe any obligations it has entered into with an investor or an investment of an investor of any other contracting party. This requirement supersedes the traditional framework of bilateral treaties. Firstly, the word "any obligations" may mean any kind of agreements, including State contracts, entered into between the host country and foreign investor. Secondly, the Energy Charter Treaty requires each contracting party to ensure that its regional and local governments have observed all the provisions of the Treaty.[52] It has therefore considerably broadened the scope of "any obligations". Thirdly, the Energy Charter Treaty provides that foreign investors and the host country may submit their investment disputes to international arbitration.[53] According to this requirement, if a host country breached the contract it entered into with foreign investor, it will constitute a breach of "any obligations", thus the affected foreign investor may submit the disputes to international arbitration. It does not mean that the host country cannot refuse to perform its obligations under the contract, including State contracts. The question is whether the host country has an obligation to appear before the international arbitration tribunal first. International practice shows that the outcome of the arbitration is a balance between the permanent economic sovereignty of a State and the binding nature of a contract. Some pointed out that "The most realistic interpretation of the intention underlying the last sentence of Article 10(1) is that the drafters, in view of this debate, wanted the Treaty to weigh in on the side of the advocates of 'sanctity of contract' versus 'permanent sovereignty' and channel such disputes to the Article 26 arbitration method."[54]

Stabilization Clauses and Change in Circumstances

Stabilization clauses are common in State contracts. The purpose is to strike a balance between the rights and obligations of the host country and the foreign investor. Under this arrangement, the host country provides the foreign investor with "a certain stability which is justified by the considerable investments which it makes in the country concerned. The investor must in particular be protected against legislative uncertainties, that is to say the risks

52 Articles 22 and 23 of the Energy Charter Treaty.

53 Article 26 of the Energy Charter Treaty.

54 T.W. Walde, *International Investment under the 1994 Energy Charter Treaty* 29 J. of World Trade 40 (1995).

of the municipal law of the host country being modified, or against any government measures which would lead to an abrogation or rescission of the contract. Hence, the insertion, as in the present case, of so-called stabilization clauses: these clauses tend to remove all or part of the agreement from the internal law and provide for its correlative submission to ..... international law system."[55] Normally, the stabilization clause states that the host country promises not to amend the contract by way of legislative amendments, not to damage the interests of the foreign investors by legislative or administrative means, nor to change the legislative environment as of the date of the contract. The meaning of "not to damage the interest of the foreign investors" includes not to nationalizing their property. A typical example of stabilization clause is in the Aminoil case, the concession agreement of which stated that "the period of this Agreement shall be sixty (60) years", "The Shaikh shall not by general or special legislation or by administrative measures or by any other act whatever annul this Agreement". The concession agreement also stated that, "no alteration shall be made in the terms of this Agreement by either the Shaikh or the Company except in the event of the Shaikh and the Company jointly agreeing that it is desirable in the interests of both parties to make certain alterations, deletions or additions to this Agreement."[56] Obviously, the provision against unilateral alteration of the agreement was mainly targeted at the Kuwait Government.

The advocates of internationalization of State contracts generally support the view that stabilization clause requires the host country to fulfil its contractual obligations, regardless of whether the provisions are excessively restrictive on the legislative or administrative power of the sovereign State. The reason is that the host country enjoys sovereign power and can amend the contract by legislative means. Thus, stabilization is necessary for the safeguard of the interest of private investors. This deduction is not free from difficulties. In general, State contracts and economic development contracts are entered into by the administrative organs of the host country. In a host country with relatively independent administrative, legislative and judicial branches, it may contravene the constitution of the host country if the contract between the administrative organ and foreign investor restricts the power of the legislative branch. If that is proved to be the case, is the stabilization clause valid? Some hold the view that a State cannot declare a contract signed with foreign investors invalid based on its own domestic laws. The basis of this argument is that one cannot expect foreign investors to have expertise in the domestic law of the host country.[57]

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55 *Texaco case*, at p17.
56 *Aminoil case*, p1020
57 See *Sapphire case*.

Some western commentators subdivide stabilization clauses into two categories, one being contractual and the other statutory. Contractual stabilization clauses refer to those under which the treatment given to foreign investors is in accordance with the foreign investment laws and the Constitution. Statutory stabilization clauses refer to those under which the host country may unilaterally amend the law irrespective of its effect on foreign investors, unless the laws of the host country have been incorporated into the contract and the host country has approved the contract. Statutory stabilization clause can be further divided into general stabilization clause and intangible stabilization clause. Under the general stabilization clause, the host country promises that only the law in force at the time of signing the contract will be applicable to the contract. Under the intangible stabilization clause, although the host country has not abandoned its legislative power by reason of stabilization clause, the host country promises not to unilaterally amend the contract during the validity of the contract, i.e. not to use sovereign power and privilege to enact laws to amend the contract.[58] The concession agreements entered into by Libyan government with foreign investors often provided "unless the parties otherwise agree, the express provisions of this concession agreement cannot be changed or amended." This kind of provision is generally regarded as intangible stabilization clause.

The theory of superiority of international law over national law serves as the basis for the validity of stabilization clauses. Some scholars argue that there is a basic legal system above the laws governing the State contracts, the former determines the validity of the latter.[59] The domestic law of the host country may apply to the State contracts, while the basic legal system i.e. international law applies to the stabilization clause. Needless to say, to divide the applicable law of State contract into domestic law and international law is not with a solid theoretical basis. That is why up till now, this theory has not received much support. As a matter of fact, putting stabilization clause under international law cannot prevent the host country from breaching the contract. Its effect is only to elevate the breach committed by the host country to the international level, which enables the home country of the foreign investor to offer diplomatic protection under international law and demand for compensation from the host country.

Generally speaking, there is a direct relationship between the debate on the validity of stabilization clause and the debate on the nature of State contracts. Those who advocate for the superiority of the stabilization clause argue that State contract is a legal arrangement which safeguards the rights and obligations

58 Weil, *Contracts entre Etats et particuliers* 128 Recueil des Cours 212 (1969).

59 See *Texaco case* and *Contracts entre Etats et particuliers.*

of the parties. It is an independent legal system free from the domestic law of the host country and the parties must abide by the principle of the sanctity of contract. This argument is not free from ambiguity. It is generally known that the validity of all contracts, agreements and treaties are stemmed from a higher level of law. Otherwise, they will be without legal basis and cannot have legal effect. State contract is no exception. It is without legal basis if State contracts form an independent legal system and are immutable and cannot be amended. In other words, if one argues for the independent legal system of State contracts, what is the legal basis for its unchangeability?

The opponents of the theory of independent legal system for State contracts or stabilization clauses argue that *pacta sunt servanda* does not apply to long-term economic development agreements. In their views, the duration of state contracts are in general more than 20 years and often involve complicated commercial arrangement. During such a long time, it is inevitable that there will be tremendous changes in the political, economic and other environment of the host country as well as the international community and international market. Whilst the circumstances of the host country and international community and market keep changing, the insistence on the immutability of State contracts will put the contracting parties, especially those of the developing countries, in a disadvantageous position. Thus, they oppose the mechanical application of *pacta sunt servanda* to State contracts, especially the long-term investment agreements such as concession agreements.

The *pacta sunt servanda* is a generally accepted principle of international law and widely accepted by the international community. However, it is undeniable that international law and the general principle of law also recognize the principle of change in circumstances, i.e. change in circumstances after a treaty or contract is entered into. And if the changes are unforeseeable or unforeseeable at the time of the making of the treaty or contract, the affected party can refuse to perform the contract or amend the terms of such documents. Thus, even if the principle of *pacta sunt servanda* is applied, it does not mean that the host country cannot amend the contract it has entered into with a foreign investor. In Revere case, the Jamaica government's refusal to perform the contract was apparently based on the principle of change in circumstances. This can be derived from Prime Minister Manley's speech to the Jamaica Teachers Association, in which he addressed the critical energy situation. He said, "Contracts for products like sugar, banana and bauxite had been signed when oil was $2.00 per barrel and not the current $14.00." As "all the fundamental equations have changed", the original contract cannot be performed.[60]

60 See *Revere Copper case*, p9. Manley stated "The Government of Jamaica cannot be bound by them

Currently, both the common law and civil law countries recognize the rights of sovereign states and other public authorities in re-negotiating or unilaterally amending, in special circumstances, their contracts entered into with private persons or enterprises based on the principle of sovereignty.[61] Thus, the principle of change of circumstances is both a principle of international law and a principle of the laws of various countries. According to the traditional international law or the general principle of law, the host country may therefore amend investment agreements, including the long-term economic development agreements in the form of State contracts. As a matter of fact, there is no absolute principle of *pacta sunt servanda* or sanctity of contract. Under all legal systems, the principle of *pacta sunt servanda* goes hand in hand with other principles. Moreover, the contract law practice of many countries shows that there is no such a thing as absolute freedom of contract. In determining the validity of a contract, the courts or arbitration tribunals must consider the bargaining power and status of the contracting parties, economic duress, the principle of irreversibility, etc.[62]

As mentioned above, one of the characteristics of State contracts and economic development contracts is the long duration. In the last few decades, both domestic and international environment changed. These changes not only affected State contracts, but also the political and legal systems of the countries concerned and other fundamental interests. Under these circumstances, the stabilization clause can no longer be stabilized and hence the western scholars began to advocate for putting the stabilization clause above the domestic legal system. This is exactly the purpose of internationalization of State contracts. Internationalization of contracts takes the stabilization clause out of the jurisdiction of the host country and at the same time the theoretical basis for internationalization of State contracts is the existence of stabilization clause. Therefore, any over-emphasis on stabilization clause is incompatible with the reality of State contracts.

The international community seems to have realized the above difficulty and has adopted a restrictive interpretation of the stabilization clause. For example, in the Aminoil case, the arbitration tribunal pointed out that it was theoretically possible for the stabilization clause to prohibit nationalization. Taking into consideration the particular importance of the undertakings, unless it was expressly stipulated in the contract itself, it might not be presumed that

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any longer. For Jamaica to survive we must negotiate new contracts and new benefits for our things sold abroad."

61 M. Singer, *The Act of State Doctrine of the United Kingdom: An Analysis, with Comparisons to United States Doctrine* 175 Am. J. Int'l L. 283 (1981).

62 P. Atyiyah, *The Rise and Fall of the Freedom of Contract*, Oxford: Clarendon Press, 1979.

the host country had accepted that obligation. In addition, the inclusion of the stabilization clause must be in conformity with the regulations governing the conclusion of State contracts and that it should cover only a relatively limited period.[63] Several principles have been derived from the Aminoil case: (1) The effect of the principle of contractual undertakings cannot supersede the principle of sovereignty, including nationalization; (2) the general stabilization clause does not have the effect of restricting the sovereign power to nationalize, unless there is express restriction in the contract which is in accordance with the domestic law of the sovereign state; (3) the restriction on the sovereign power in the stabilization clause must be limited in time and the duration should not be long.

The principles pronounced in Aminoil case have also been followed in contractual practice. For example, in 1984, Ghana government and Kaiser Aluminum & Chemical Co. successfully re-negotiated its long-term contract on the supply of electricity. The new contract abolished the original broad provisions of stabilization clause which were replaced by a five-year restrictive provision on Ghana.[64] The Kaiser Aluminum & Chemical Co. also successfully re-negotiated with Jamaica Government regarding bauxite in the 1970's.[65]

The international practice of State contracts in the past 30 years shows that the principle of *pacta sunt servanda* has the tendency of being replaced by the principle of sovereignty. Many host countries and transnational corporations have had experience in amending their contracts. Although many contracts were amended after the independence of former colonies,[66] a number of contracts were renegotiated and amended at the initiative of transnational corporations. The practice of international arbitration also demonstrates this trend. In the well known the U.S. and Iranian claims cases, the tribunal recognized the principle of change of circumstances. The Questech Inc. case is an example. In that case, the Iranian government and an American company entered into a contract in which the latter was responsible for developing the electronic information system for the former. After the new Iranian government was established, it refused to perform the contract based on change of circumstances. The arbitration tribunal considered: "The fundamental changes in the political conditions as a consequence of the Revolution in Iran, the different attitude of the new government and the new foreign policy especially towards the United States which had considerable support in large sections of

63 *Aminoil case*, p1023

64 The re-negotiated agreement between Ghana and Kaiser Aluminum & Chemical Co. was signed in July, 1984.

65 See Samuel K. B. Asante, *"International Law and Investments"*, in Mohammed Bedjaoui (ed) *International Law: Achievements and Prospects*, Martinus Nijhoff Publishers, Paris, 1991, 687, at 681.

66 See *Aminoil case*.

the people, the drastically changed significance of highly sensitive contracts... especially those to which United States companies were parties."[67] Thus, the arbitration tribunal upheld Iran's refusal to perform the contract.

It goes without saying that to argue that the host countries have the right to amend State contracts, including the stabilization clause, does not mean that the principle of *pacta sunt servanda* is not important. In order to attract foreign investment, it is necessary for the host countries to abide by the promise they make with foreign investors. Besides, when exercising the sovereign power to amend the contracts, the countries concerned must abide by the principles of international law, including adequate protection of foreign investors and the principle of non-discrimination. Regarding this point, the sole arbitrator of Shufeldt, P.W. case (United States v Guatemala) wrote, "it is perfectly competent for the Government of Guatemala to enact any decree they like and for any reasons they see fit and such reasons are no concern of this Tribunal. But this Tribunal is only concerned where such a decree, passed even on the best of grounds, works injustice to an alien subject, in which case the Government ought to make compensation for the injury inflicted and cannot involve any municipal law to justify their refusal to do so."[68]

Taking into consideration the special characteristics of State contracts, a number of politicians, including the former Secretary General of ICSID and academics generally support the view that long-term economic development contracts should stipulate the mechanism for amending contractual obligations in case of change of circumstances. This is the mainstream view of the international community and reflects the reality of this highly globalized world.

The Applicable Law

The determination of applicable law is an important issue. According to the recognized principle of private international law, if there is no express choice of applicable law in the contract between a host country and a foreign investor, the interpretation of the contract should be based on the law of the country which has the closest connection with the contract. As the subject matter of most State contracts are located in the host country, and the contracts are preformed in the host country, the law of the host country should be the governing law. The earlier international arbitration practice supported this view. For example, the arbitrator of the Quatar case pointed out that, having considered the subject matter of the contract in question and that one of the contracting parties was a State, the applicable law should be Islamic law.[69] In the Abu

67 See the discussion on *Questech, Inc.* v. *Ministry of National Defence of the Islamic Republic of Iran*, 80 Am. J. Intl'l L 362 (1986).

68 See Digest of International Law, Vol 6, p47.

69 20 ILR, 534 (1953).

Dhabi case, the arbitral tribunal held the same view. He said, "This is a contract made in Abu Dhabi and wholly to be performed in that country. If any municipal system of law were applicable, it would prima facie be that of Abu Dhabi."[70] Nevertheless, in all the above cases, the arbitral tribunals refused to apply the Islamic law for the reason that Islamic laws lacked provisions on concession agreements. It is, however, very debatable whether or not the Islamic law was capable of resolving the disputes at that time.

Regarding the choice of applicable law of State contracts, the effect of the Aramco case is considerable.[71] In that case, after the concession agreement between Saudi Arabia and Aramco was entered into, it was subsequently assigned to a third party. Aramco considered the above act by the host country as having breached their contract. However, the concession agreement had no express provision governing the applicable law and arbitration proceedings. After the dispute arose, Saudi Arabia and Aramco agreed to submit the dispute to international arbitration. The two parties agreed that the dispute should be decided in accordance with the Saudi Arabia law in so far as matters within the jurisdiction of Saudi Arabia are concerned, and in accordance with the law deemed by the Arbitral Tribunal to be appropriate in so far as matters beyond the jurisdiction of Saudi Arabia are concerned. The arbitration tribunal ruled "The law in force in Saudi Arabia should also be applied to the content of the Concession because this State is a Party to the agreement, as grantor, and because it is generally admitted, in private international law, that a sovereign State is presumed, unless the contrary is proved, to have subjected its undertakings to its own legal system. This principle was mentioned by the Permanent Court of International Justice in its judgments concerning the Serbian and Brazilian Loans."[72] However, the tribunal added that the law of Saudi Arabia must be interpreted or supplemented by the general principles of law, by the customs and practices in the oil business and by concepts of pure jurisprudence.

The above cases show that while the law of the host countries should be the applicable law, the arbitral tribunals considered the law of those countries as imperfect and had no relevant provisions on concession agreements. Thus the arbitral tribunals must refuse the application of the law of the host countries and instead adopt the general principles of law to fill the gap. Strictly speaking, it was not an invention of the arbitral tribunals that the general principles of law should apply in the absence of relevant legal provisions in the law of the host country concerned. As early as 1900, this rule was applied in the Delgoa Bay Railway case which concerned a Railway Construction Agreement in

70 18 ILR 144 (1951).
71 *Aramco case.*
72 *Aramco case*, at p1125-1126.

Portugal. The arbitration tribunal held that the law of the host country should be the applicable law but pointed out that the Portuguese law on the subject matter was not different from the general principles of law of the modern countries.[73] In another case of 1973, the relevant agreement stipulated the law of Guatemala to be the applicable law. The arbitration tribunal held that the law of Guatemala was consistent with the laws of other countries.[74] As a matter of fact, the above two arbitral tribunals merely mentioned the general principles of law without actually applying the same. What they were trying to do was that the same result would be arrived at even when the law of other countries was applied. The purpose of taking such an approach was of course to evade potential criticisms.

In a word, in the 19th century and the earlier 20th century, it was common for the State contracts on international investments entered into by host countries, especially the developing host countries with foreign private investors to require the law other than that of the host country in question to be the applicable law. For example, the Consortium Agreement of Iran entered into in 1954 provided that "In view of the diverse nationalities of the parties to this Agreement, it shall be governed by and interpreted and applied in accordance with principles of law common to Iran and the several nations in which the other parties to this Agreement are incorporated, and in the absence of such common principles, then by and in accordance with the principles of law recognized by civilized nations in general, including such of those principles as may have been applied by international tribunals."[75] This provision was in fact copied from the third source of international law within Article 38 of the Statute of the International Court of Justice. As most of the arbitrators of international arbitration are from developed countries, they always regard *pacta sunt servanda* as part of the general principles of law. In other words, the host country of international investment may not refuse to perform or unilaterally cancel the contract. Any analysis of international arbitration must take into consideration this background.

Parties to State contracts sometimes may, by mutual agreement, choose international law as the applicable law. In this regard, the amended oil exploitation agreement between the Libyan government and the Libyan American Oil company read: "This Concession shall be governed by and interpreted in accordance with the principles of international law, and in the

73 Delgoa Bay Railway Case in M. Whiteman (ed), *Damages in International Law*, Washington DC., Vol 3, 1976, p1694.

74 Decision of the Arbitrator in Claim by the United States of America on behalf of P.W. Schufeldt v the Republic of Guatemala, 24 Am. J. Int'l L 799 (1930).

75 Cited from E. I. Nwogugu, *Legal Problems of Foreign Investments, Collected Courses of The Hague Academy of International Law* (1976), Martinus Nijhoff Publisher, 1983, The Hague, at 216.

absence of such common principles then by and in accordance with the general principles of law as may have been applied by international tribunals"[76] Some commentators regarded such arrangement as having taken into consideration the interests of the host country and the needs of foreign investors. "Their choice served the interests of the State by submitting the contract initially to the State's own legal system and by placing activities that are to be undertaken in a large measure in Libya within its legal system. The provision also protected the private foreign entities contracting with the State by requiring that only principles of Libyan law common to international law be applicable, which ensured against unilateral and arbitrary changes in, and eliminated aberrational aspects of Libyan law."[77] The characteristic of the above oil exploitation agreement is that only when the law of the Libyan and international law were the same would the former be applied. Any principles of Libyan law which were inconsistent with international law would not be applied. This provision in fact did not intend to apply the law of the host country. Another question is the ascertainment of international law. It is always controversial as to what are the principles of international law or the general principles of law. The most commonly recognized principle that is considered as having acquired the status of the principle of international law should be the principle of sovereignty. It could be presumed that the Libyan law also had such a principle. According to the principle of sovereignty, the Libyan government should have the power to nationalize or expropriate foreign investment despite the above provision of the agreement. Nevertheless, such an interpretation would be unfavourable to the foreign investors and would therefore not be the intention of the contracting parties. As result, only could the international arbitration tribunal decide what were the common principles of international law and Libyan law (This was what happened later). Should the international arbitration tribunal be unable to decide what were the common principles of Libyan law and international law, the applicable law would then be the general principles of law. In the circumstance, the issue will go back to square one, i.e., internationalization of State contracts. Needless to say, the fact that the contract entered into was in the 1960's made a big difference, as at that time, it was not inconceivable to have the above provisions incorporated into economic development contracts between transnational corporations a developing host country. Yet with the world being increasingly globalized and especially the developing countries competing for foreign investment today, one should not be surprised if similar arrangements are made between foreign investors and a host country.

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76 The Oil Exploitation Agreement between Libyan government and Libyan American Oil Company (20th Jan 1966 amended).

77 *LIAMCO* case.

The issue of choice of law of the Revere Copper case also merits attention. The agreement in question had no stipulation on the applicable law. According to the recognized principle of private international law on choice of law, the arbitration tribunal should have applied the law of Jamaica which was the host country. The arbitration tribunal on the one hand accepted that Jamaican law was the applicable law, but on the other hand emphasized that Jamaican law did not preclude "the application of principles of public international law", according to which States must be liable to pay damages for breach of contracts. The case involved an issue that Jamaica refused to perform the contract it entered into in conflict with "its prior undertakings and assurances given in good faith to encourage foreign investments."[78] As the agreement did not have a choice of law clause, and the agreement was entered into and performed in Jamaica, Jamaican law should have been decided the applicable law. Then why did the arbitration tribunal rule the applicable law not to be that of the host country? The arbitral tribunal stated "In recent years, however, a series of decisions by Arbitration Tribunals, applying the views of outstanding international jurists, has developed an exception to this narrow approach where contracts fall within a category known as long term economic development agreements. In such cases, the question of breach is not left to the termination of municipal courts applying municipal law. The reason for this is that such contracts, while not made between governments and therefore wholly international, are basically international in that they are entered into as part of a contemporary international process of economic development, particularly in the less developed countries. The very reason for their existence is that the private parties entering into such agreements and committing large amounts of capital over a long period of time require contractual guarantees for their security; governments of developing countries in turn are willing to provide such guarantees in order to promote much needed economic development. Moreover, while the agreements are entered into between governments and private parties, the governments of such parties are very much interested in such agreements and in promoting their conclusion. In this instance, the government of the investor provided its own guarantee for the investment in addition to the contractual guarantee furnished by the foreign government."[79] The arbitration tribunal of Revere Copper case held that the agreement between Jamaica and the American investors fell within the category of long term economic development agreement and that principles of public international law should apply insofar as the state government which was a party was concerned. This conclusion was no different from treating transnational corporations on the same footing with States. Besides, the basis of this conclusion that otherwise foreign investors could not

78 *Revere Copper case*, p1331.
79 *Revere Copper case*, p1331.

receive fair and equitable treatment under the law of the host country was not without doubt.[80]

In Sapphire case, the agreement did contain a choice of law clause but it also stipulated that the parties must perform the contract in good faith. The arbitration tribunal in that case considered the contract as having the quasi-international character and therefore it should not be governed by the domestic laws of any country or by any special legal system. It concluded that the general principles of law based on the customs of the civilized nations should apply. This was because the principle of *pacta sunt servanda* was the basis of all contractual relations. In other words, the principle of *pacta sunt servanda* was equally applicable to concession agreements and state contracts.

Some other commentators argue that the municipal law chosen by the contracting parties to State contracts "does not therefore apply in itself but as a law of renvoi. The presence in the contract of a provision referring to the municipal law of the host State does not therefore necessarily mean that internationalization must be ruled out: if such internationalization results from the other characteristics of the contract - and this is the case with most economic development agreements."[81]

Recent literatures also supported the applicability of the general principles of law in concession agreement. The early authority McNair once pointed out in his article that if the law of the host country lacked some important principles, then the general principles of law should be applied.[82] It should be pointed out however that McNair made a precondition for applying the general principles of law i.e. the law of the host country lacked some important principles. Nevertheless, he has always been regarded as the first advocate of the theory by the supporters of internationalization of concession agreements.

In any event, both international practice and theory manifest that the contracting parties to State contracts have the full autonomy in choosing the applicable law, including the law of the host country and the general principles of law. If there is no express choice of law clause in the contract in question, the applicable law should be the law which has the closest connection. This private international law principle has been increasingly recognized by the international community. International practice does not negate this principle either.

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80 The arbitration tribunal quoted the opinion of academics by stateing "Whatever the position may be under municipal law, it would be contrary to well established principles of international law to leave the question of State responsibility to the alien party to the determination by that State as to what it lawfully could or could not do. " See Revere Copper case, p1331. Strictly speaking, the above views have not received wide support from the international community. It can, at best, represent the interests of transnational corporations.

81 See *Texaco case*, p18.

82 McNair, *The General Principles of Law Recognized by Civilized Nations* 33 Brit.Y.B. Int'l L, 1 (1957).

Conclusion

In conclusion, the nature of State contracts, internationalization of State contracts, liability of the State to compensation, the effect of stabilization clause and the applicable law are all important issues in the contemporary international law. This is more so with the widespread of globalization from economic sectors to other frontiers. The direct causes of disputes over the theory of State contracts included the de-colonization activities in the mid 20th century and the subsequent nationalization and renegotiations of concession agreements. After debating for more than half a century, opinions on many issues are still divided and no consensus can be reached. This is because in the past, every theory represents the interests of a specific economic group or a specific state group. On the whole, such theories focused on the obligations of and were therefore unfavourable to the developing host countries. However, as norms governing the behaviour of the international and national community, any principles of international law and municipal law must have a certain degree of objectivity and stability. From this perspective, some principles which are advantageous to some States or economic groups may turn out to be disadvantageous tomorrow to the same states or groups. Besides, with the growing globalization, the exercise of the principle of sovereignty is being restricted. Matters that were originally regarded as internal and therefore under the absolute control of states have now been directly or indirectly governed by the norms of international organizations and international treaties. This phenomenon will have an important repercussion on the attitude of the states towards State contracts. In the past few decades, the developing host countries have gained much more influence in the international community. Yet, with the world being fast globalized, its power structure has changed and is still being changed. Such changes will have important effects on direct foreign investment, the principles of sovereignty, the attitudes of developing countries toward transnational corporations and the formation and performance of State contracts.