ILLEGALITY OF STATE CONTRACTS UNDER INTERNATIONAL LAW

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I INTRODUCTION

This article explores how general principles of international law are identified and applied to the issue of illegality of state contracts under international law.

It commences by examining the circumstances in which a state contract governed by international law is considered illegal under international law and the consequences of such illegality. This study is necessary for two main reasons. First, the legality or illegality of a contract under its own governing law is of critical importance for its validity. While a contract may, during its life, have contact with several legal systems, it is primarily the governing law that determines the existence of the contract and the rights and obligations of the parties under it.[1] Thus, any illegality under that legal system is likely to have fundamental consequences for the contract. Secondly, in the many cases where international law is said to be the governing law of the contract or part thereof, the legality or illegality of the contract must necessarily be ascertained under international law. Before signing a state contract and making it subject to international law, the parties, or their legal advisors, must assess the legality of its terms under international law. In case a dispute arises from such a contract, the party against whom a breach of contract has been alleged should check whether a defence of illegality may be raised under international law. Where such a defence is indeed raised, the tribunal hearing the dispute must examine it by reference to international law. Any other legal system, such as the law of the host state, may become relevant only insofar as the tribunal is referred to it by international law itself or any conflict rules that bind the tribunal.

Given such necessity in assessing the legality of state contracts under international law, it is important to ascertain the substantive rules of international law on this subject. The difficulty with this exercise is that the existing rules of international law on the subject are scant. One can hardly find any treaty rules or rules of customary international law, either directly or by analogy, dealing with the subject of illegality of state contracts. As a result, for some important issues concerning when a contract is considered illegal and what the consequences are for the illegality, it will be necessary to identify and apply general principles of law. This process is often difficult and rather uncertain.

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1 Other laws may also be relevant (to a lesser extent) such as the law of the forum or the law of the place of performance.

Regarding the substantive content, as it is obviously not possible to set out a comprehensive framework of international law on this topic, this article will only deal with the most fundamental and practically relevant issues. First, it will examine the sources and effect of illegality of state contracts under international law. Second, it will examine the relevance under international law of an illegality under the domestic law of the host state. Such an illegality is traditionally irrelevant to the legality of a state contract under international law. However, certain provisions in a Bilateral Investment Treaty ('BIT') regarding compliance with the law of the host state may have important implications for this issue.

II SOURCES AND EFFECT OF ILLEGALITY OF STATE CONTRACTS UNDER INTERNATIONAL LAW

For convenience, this section is divided into three sub-issues. First, this section will consider what the sources of illegality are for a state contract under international law. As shown below, these are rules of international law that impose mandatory obligations on the parties, mainly the host state, and with which the terms of the contract conflict. Secondly, this section will examine whether such a conflict necessarily makes the contract illegal under international law. In other words, it is necessary to consider the circumstances that make a contract illegal under international law. Thirdly, this section will consider the consequences of illegality for a state contract under international law. These issues will now be examined in turn.

A *Sources of Illegality of State Contracts under International Law*

A direct source of illegality for a contract would be a legal rule that expressly classifies that contract as illegal. However, such a rule is hard to find even in national legal systems and, under international law, does not seem to exist. Instead, the illegality of a contract under most legal systems often derives from the fact that the conduct or obligation that must be or has been carried out by one or both parties under the contract is prohibited by law.[2] The sources of illegality for a contract therefore mostly lie in the legal rules that prohibit the conduct of the parties under the contract or, in other words, render such conduct illegal. For that reason, the starting point in determining whether a contract is illegal under international law is to identify the rules of international law which render the conduct or obligation of the parties under the contract illegal. Those are potentially the sources of illegality for the contract. Whether the illegality of

2 Jack Beatson, *Anson's Law of Contract* (Oxford University Press, 28th ed, 2002) 348; Hugh Beale (ed), *Chitty on Contracts* (Sweet & Maxwell, 29th ed, 2004) 947–52; Ewan McKendrick, *Contract Law* (Palgrave, 7th ed, 2007) 330–4; *Code civil* [Civil Code] (France) art 1133; Barry Nicholas, *The French Law of Contract* (Oxford University Press, 2nd ed, 1982) 128–9.

such conduct makes the contract itself illegal is a separate question which will be considered next.

A rule of international law may make certain conduct illegal per se, regardless of its author. For example, it is an accepted rule of customary international law that torture is an international crime. Therefore, the commission of torture is always illegal under international law, whether perpetrated by an individual, an organisation or a state.[3] However, such rules are rare. More often, international law prohibits conduct only if it breaches an obligation that international law imposes on its author. Such an author, in the context of a state contract, is often the host state rather than a foreign investor, for example, because most obligations in international law are imposed on states, not private parties. For example, harming an endangered species is not illegal per se under international law. If this conduct is carried out by an individual or a state that is not a party to an international convention on the protection of endangered species, no internationally illegal conduct has occurred. However, if this is committed by a state that is a party to such a convention, then it is a breach of a treaty obligation and constitutes illegal conduct under international law. This is the kind of conduct which entails international responsibility under the rules of state responsibility stated in the *Articles on State Responsibility* submitted by the International Law Commission to the UN General Assembly in 2001 ('*ILC Articles*').[4] Although the *ILC Articles* describe such conduct as 'wrongful', their commentaries, as well as the judgments of international tribunals referred to therein,[5] consistently refer to it as 'illegal'.[6] Similarly, leading authors also describe such conduct as illegal under international law.[7] Thus, if the conduct of a host state under a state contract is in breach of one of their international obligations, the conduct is considered illegal under international law and this potentially makes the contract itself illegal.

The foreign investor may argue that the breach by the host state of an obligation it owes another state should have no effect on the contractual relationship between it and the investor. The investor is a complete stranger to the duty that the host state has under international law. Where the host state breaches an international obligation under a treaty with another state, for example, it shall bear the consequential responsibility to the other state under international law. However, that should have no effect on the validity of the contractual relationship between the host state and the foreign investor. In other words, from the perspective of

3 Antonio Cassese, 'International Criminal Law' in Malcolm D Evans (ed), *International Law* (Oxford University Press, 2006) 719.

4 International Law Commission, *Responsibility of States for Internationally Wrongful Acts*, GA Res 56/83, UN GAOR, 56th sess, Agenda Item 162, UN Doc A/RES/56/83 (12 December 2001) annex art 2(b).

5 See *Dickson Carwheel Company Case (United States of America v United Mexican States)* (1931) 4 UN RIAA 669; *Elettronica Sicula SpA Case (ELSI) (United States of America v Italy) (Judgment)* [1989] ICJ Rep 15; *Factory at Chorzow (Germany v Poland) (Merits)* [1928] PCIJ (ser A) No 17.

6 James Crawford, *The International Law Commission's Articles on State Responsibility* (Cambridge University Press, 2002) 74, 89, 202.

7 Ian Brownlie, *Principles of Public International Law* (Oxford University Press, 6th ed, 2003) 85, 420, 485; Rosalyn Higgins, *Problems & Process: International Law and How We Use It?* (Oxford University Press, 1994) 164; Ivan Shearer, *Starke's International Law* (Butterworths, 11th ed, 1994) 269.

the foreign investor, the breach of the treaty by the host state is irrelevant in determining the legality of the contract.

However, this argument does not hold where the contract is governed by international law. In such a situation, the rules of international law which impose obligations on the host state at the same time form part of the legal system which governs the validity of the contract. The obligations of the host state under international law are now not merely obligations it owes another party and therefore irrelevant to the validity of the contract with the investor. They are the reference point for determining the legality and validity of the terms of the contract between the host state and the investor. Thus, where the contract requires the host state to engage in conduct that is prohibited by international law, international law, as the governing law of the contract, can have an effect on the legality of the contract. The fact that the investor is a stranger to the rule of international law in question does not change this reality. In fact, in circumstances where the parties choose international law, the investor, as a contracting party, must respect the relevant rules of international law and should not aid and abet the host state in breaching international law in concluding and performing the contract. Complicity in breaching international law has been said to constitute an illegal act under international law as well.[8]

In order to illustrate the points made above, it is useful to describe some state contract cases where a conflict between the conduct of the host state under the contract and its international obligations was or could have been identified, potentially rendering the contracts illegal under international law.

1 SPP v Egypt[9]

In 1974 Southern Pacific Properties ('SPP') entered into contracts with Egypt to build a commercial resort in the pyramid area. In 1975 the Egyptian government issued approvals for the project. However, in 1978, due to political opposition to the project, the Egyptian government withdrew all such approvals, causing SPP to shut down the project and suffer substantial losses. SPP then brought an International Centre for Settlement of Investment Disputes between States and Nationals of Other States ('ICSID') arbitration claim against Egypt for expropriating its property, including its contractual rights under the contracts. The Tribunal, holding it could apply international law, awarded compensation against Egypt for having expropriated SPP's property.

The aspect of the case relevant to this article is that after the contracts were concluded, the project site became protected by the *UNESCO Convention concerning the Protection of World Cultural and Natural Heritage 1972* ('*UNESCO Convention*'), which entered into force on 17 December 1975 and to which Egypt was a party. Under the *UNESCO Convention*, each contracting state

8 John Ruggie, *Protect, Respect and Remedy: A Framework for Business and Human Rights*, UN HRC, 8th sess, Agenda Item 3, UN Doc A/HRC/8/5 (7 April 2008) 20.

9 *Southern Pacific Properties (Middle East) Ltd v Arab Republic of Egypt* (1983) 3 ICSID Rep 46) ('*SPP v Egypt*').

has the duty to protect the heritages nominated by it and approved by the World Heritage Committee. The pyramid area was nominated by Egypt and approved by the World Heritage Committee in February 1979. Therefore, from that point in time, as held by the Tribunal, the continued construction of the resort on this site would have been a violation of the *UNESCO Convention* and hence illegal under international law.[10] This was one of the reasons for which the Tribunal rejected the claim by SPP that it should be compensated for the value of the project throughout its duration (up to 1995), to be calculated according to the discounted cash flow ('DCF') method. The Tribunal stated that even if it was willing to adopt this calculation method, it would only award compensation up to 1979 because the project:

> would have been illegal under both international law and Egyptian law after 1979, when the registration [under the *UNESCO Convention*] was made … From that date forward, the Claimants' activities on the Pyramids Plateau would have been in conflict with the Convention and therefore in violation of international law, and any profits that might have resulted from such activities are consequently non-compensable.[11]

The merit of the decision to refuse to award such compensation, implicitly on the ground that the contract was illegal, will be discussed later in this article. For the present, it suffices to note that this case is an example of conduct by the host state which, if carried out, would contravene a treaty obligation and hence would be illegal under international law. The Tribunal in fact referred to 'the Claimants' activities' as being illegal under international law. Strictly speaking, it was mainly the conduct of Egypt, not SPP, that was illegal because SPP, being a private investor, was not subject to the conservation obligation under the *UNESCO Convention*. However, SPP could still be said to have wrongfully assisted Egypt in breaching an international obligation.

2 Sandline v PNG[12]

In this case, Sandline was engaged by Papua New Guinea ('PNG') to provide military services to suppress a secessionist movement in its territory. When PNG refused to make the payment under the contract, Sandline brought an arbitration claim against PNG for breach of contract. PNG raised the defence that the contract was illegal under the law of PNG and therefore unenforceable under English law, the governing law stipulated in the contract. The Tribunal held that international law was applicable which prevented PNG from raising illegalities under its own law to justify its non-performance of the contract:

> In these circumstances, for the reasons above, a valid contract was concluded between Sandline and PNG, notwithstanding any failure to

10 Ibid 225.

11 Ibid 234–5.

12 *Sandline International Inc v The Independent State of Papua New Guinea* (1998) 117 ILR 552 ('*Sandline*').

> observe the constitutional and other statutory provisions upon which PNG relies to establish the illegality or unlawfulness of the agreement or lack of capacity to enter into it. Any such illegality or unlawfulness or lack of capacity arose, if it arose at all, under the internal laws of PNG and not under international law which, for the purpose of determining the validity of a contract, disregards the internal laws of a contracting state. The agreement was not illegal or unlawful under international law or under any established principle of public policy.[13]

As the contract was held to be governed by international law, any illegality under the law of PNG was irrelevant. However, it became necessary to consider the legality of the contract under international law. On this point, as seen above, the Tribunal simply stated that the contract was 'not illegal or unlawful under international law', without conducting any examination of the issue or citing any basis for this conclusion. In fact, the Tribunal did not seem to give much thought to this point at all.

Unfortunately, this assertion seems unconvincing because the legality of the use of mercenaries is highly questionable under international law and this should have been examined closely. The use of mercenary services has been prohibited by several international instruments, including the 1989 *UN Convention against the Recruitment, Use, Financing and Training of Mercenaries*,[14] and the 1977 *Organisation of African Unity Convention for the Elimination of Mercenaries in Africa*.[15] PNG itself was not a party to these instruments, but one could have asked whether there existed a rule of customary international law against the use of mercenaries by states. The literature on international law is abundant with materials condemning the use of mercenary services as illegal.[16] The Annual Reports of the Special Rapporteur of the Commission of Human Rights to the UN General Assembly on the use of mercenaries[17] frequently referred to the use of mercenaries as 'intrinsically illegal'[18] or 'intrinsically illegal and immoral'[19]

13 Ibid 563.

14 *Convention against the Recruitment, Use, Financing and Training of Mercenaries*, opened for signature 4 December 1989, 2163 UNTS 75 (entered into force 20 October 2001).

15 *Organisation of African Unity Convention for the Elimination of Mercenaries in Africa*, opened for signature 3 July 1977, 1490 UNTS 89 (entered into force 22 April 1985).

16 See Marie-France Major, 'Mercenaries and International Law' (1992) 22 *Georgia Journal of International and Comparative Law* 103; Niall Canny, 'A Mercenary World: A Legal Analysis of the International Problem of Mercenarism' (2003) 3 *University College Dublin Law Review* 33; Richard Akinjide, 'Mercenarism and International Law' (Lecture delivered at the International Law Seminar, Palais de Nations, Geneva, 27 May 1986).

17 See *Special Rapporteur of the Commission on Human Rights on Use of Mercenaries as a Means of Impeding the Exercise of the Right of Peoples to Self-determination*, Office of the United Nations High Commissioner for Human Rights <http://www2.ohchr.org/english/issues/mercenaries/specialrap.htm>.

18 Enrique Bernales Ballesteros, Special Rapporteur, *Report on the Question of the Use of Mercenaries as a Means of Violating Human Rights and Impeding the Exercise of the Right of Peoples to Self-determination*, 50th sess, Agenda Item 9, UN Doc E/CN.4/1994/23 (12 January 1994) [17].

19 Enrique Bernales Ballesteros, Special Rapporteur, *Report on the Question of the Use of Mercenaries as a Means of Violating Human Rights and Impeding the Exercise of the Right of Peoples to Self-determination*, 54th sess, Agenda Item 7, UN Doc E/CN.4/1998/31 (27 January 1998) [68].

and described contracts for using mercenaries as illegal.[20] Some commentators have expressly viewed the use of mercenary forces in the *Sandline* case as illegal under international law.[21] It is not possible here to examine this issue in detail. It suffices to say that it is possible that there was a conflict between the conduct of PNG in this case and rules of customary international law. If there had been, the conduct of PNG could have been considered illegal under international law. It was unfortunate that this point was not examined in detail as it may have had serious consequences for the contractual claims of Sandline.

3 Aguas del Tunari v Bolivia[22]

In some situations, the conflict between the conduct of the host state and the relevant rule of international law may be less clear and direct than in the above two cases. An example is the water concession contract concluded by Bolivia in the 'water war' which was widely covered in the international media several years ago. Relevantly, on 3 September 1999 the Bolivian government entered into a concession contract with Aguas del Tunari ('Aguas') whereby Aguas was given the concession to provide water to the region of Cochabamba in Bolivia for 40 years. After the concession took effect, Aguas exercised its right under the contract and raised the water rates. This triggered widespread protests by local people, who considered the increased rates too expensive. The protests became violent and eventually caused the Bolivian government to terminate the concession contract with Aguas in April 2000. Consequently, Aguas brought an ICSID arbitration against Bolivia claiming breaches of contract and the relevant BIT.[23] An objection by Bolivia to the jurisdiction of the Tribunal was rejected and the Tribunal ordered the parties to proceed to a hearing on the merits. However, the case was subsequently settled.

While details of the contract are not publicly known, it seems possible that the concession contract with Aguas could have had an effect which conflicted with Bolivia's obligations as a party to the *International Covenant on Economic, Social and Cultural Rights* ('*ICESCR*').[24] Under the *ICESCR*, Bolivia is obliged to 'take steps with a view to achieving progressively' the implementation of basic human rights recognised under the *ICESCR*, including the right to health,[25] which

20 Enrique Bernales Ballesteros, Special Rapporteur, *Report on the Question of the Use of Mercenaries as a Means of Violating Human Rights and Impeding the Exercise of the Right of Peoples to Self-determination*, 50th sess, Agenda Item 9, UN Doc E/CN.4/1994/23 (12 January 1994) [39].

21 Damian Sturzaker and Craig Cawood, 'The Sandline Affair: Illegality and International Law' (1999) 13 *Australian International Law Journal* 214, 215.

22 *Aguas del Tunari v Republic of Bolivia (Jurisdiction)* (ICSID Arbitral Tribunal, Case No ARB/02/3, 21 October 2005).

23 Ibid.

24 *International Covenant on Economic, Social and Cultural Rights*, opened for signature 16 December 1966, 993 UNTS 3 (entered into force 3 January 1976).

25 Ibid art 12.

in turn includes the right to water.[26] The right to water is often said to be a basic human right that every state must protect.[27] In this case, if Bolivia had permitted Aguas, through the contract, to raise water rates to a level that could have had the effect of preventing Bolivia from fulfilling this international obligation, Bolivia's conduct would have conflicted with international human rights law and hence would have been illegal under international law.

The foreign investor, Aguas, could then have strongly argued that the relevant conduct of Bolivia was only to conclude a water concession contract, which cannot be illegal per se. In fact, it could be said that an important purpose in concluding the water concession contract was to provide people with water, in fulfilment of Bolivia's human rights obligations. For the investor, the water rates had to be fixed at a level that guaranteed the recovery of its investment and a margin of profits. If the water rates proved too expensive for certain groups of the population, then Bolivia could fulfil its human rights obligations by, for example, subsidising the water rates or arranging other sources of water supply for such groups. It would then have been the failure by Bolivia to take these measures that caused it to fail to fulfil its human rights obligations, rather than the conclusion of the concession contract itself.

It is true that the conclusion of the water concession contract itself did not conflict with any rules of international law. However, it does not necessarily follow that the terms of a concession contract can never conflict with rules of international law. A water concession contract may contain terms which, if observed by a country in Bolivia's situation, would result in a conflict with its international obligations. For example, Bolivia could have agreed in the contract that Aguas had total discretion to increase water rates in a reality where they were unable to provide any subsidy or any other source of water supply for the people. If Aguas increased the water rates to an unaffordable level for a group of Bolivian people, then the conduct of Bolivia in permitting Aguas to do so, as per the contract, would have resulted in a conflict with its international obligation to provide its people with water. The real difficulty here, however, would have been determining the point at which the conflict occurred, as it would have involved assessing the ability of Bolivia to find alternative means to fulfil its obligation and the level of price which would have been unaffordable for the Bolivian population. This is exacerbated by the difficulty, as pointed out by a commentator,[28] in determining the precise scope of the duty of states under the *ICESCR* to 'take steps with a view to achieving progressively' the realisation of the right to water. While in theory there must have existed a point at which the duty of Bolivia under the contract would have

26 Economic and Social Council, *General Comment No 15: Substantive Issues Arising in the Implementation of the International Covenant on Economic, Social and Cultural Rights: The Right to Water (Articles 11 and 12 of the International Covenant on Economic, Social and Cultural Rights)*, 29th sess, Agenda Item 3, UN Doc E/C12/2002/11 (11–29 November 2002); Ryan Suda, 'The Effect of Bilateral Investment Treaties on Human Rights Enforcement and Realisation' in Olivier Schutter (ed), *Transnational Corporations and Human Rights* (Hart, 2006) 73.

27 Salman M A Salman and Siobhan McInerney-Lankford, *The Human Right to Water: Legal and Policy Dimensions* (World Bank, 2004).

28 Ursula Kriebaum, 'Privatising Human Rights: The Interface between International Investment Protection and Human Rights' (2006) 3(5) *Transnational Dispute Management* 9.

come into conflict with its international obligations, that point would have been difficult to determine in practice.

In summary, this case is an example of conduct of the host state which may have conflicted with its international obligations. The conflict in this case is less direct than in *Sandline* or *SPP v Egypt*. However, if conflict could have been proven, it would have had important consequences for the contract under international law.

4 *Stabilisation Clauses: The Chad–Cameroon Pipeline Project*

On the issue of the interplay between concession contracts and international human rights law, some concern has been expressed regarding the possible conflict between stabilisation clauses, often found in concession contracts, and international human rights obligations of host states. Stabilisation clauses are clauses through which the host state agrees to 'freeze' its legal rules as applicable to the investor at a particular point in time and to not apply any new, more stringent rules to the investor in the future. Alternatively, the host state may undertake to reimburse the investor for any costs the investor incurs in having to apply the new legal rules enacted by the host state. It has been said in a legal report prepared by Amnesty International in 2005 that these stabilisation clauses could have the effect of preventing host states from complying with their international human rights obligations.[29] A more recent study, issued by the International Finance Corporation in March 2008, on stabilisation clauses and human rights law has confirmed this by stating that stabilisation clauses may have a negative impact on the ability of host states to implement their human rights obligations.[30] The 2005 report by Amnesty International referred specifically to the contracts entered into by Chad and Cameroon with a consortium led by ExxonMobil to give the consortium the concession to extract and transport oil through a long pipeline. Each of these contracts had a stabilisation clause which guaranteed the stability of the legal regime for the project such that no future regulations would apply to the contracts if they had the effect of increasing the obligations of the concession holders. For example, the contract with Chad (called a Convention) contained the following clause:

> During the term of this Convention, the Republic of Chad guarantees that no governmental act taken after December 19, 1988 will be applied to TOTCO [ie the concessionaire], without prior agreement between the Parties, which has the duly established effect of increasing, directly, indirectly or by virtue of its application to Shareholders, the obligations and charges imposed by this Convention or which has the effect of adversely

29 Amnesty International also issued a report in 2003 on similar issues for the Baku-Tbilisi-Ceyhan project which prompted BP subsequently to amend its contracts — Amnesty International, 'Human Rights on the Line: The Baku-Tbilisi-Ceyhan Pipeline Project' (Report, Amnesty International, 20 May 2003) <http://www.amnesty.org.uk/uploads/documents/doc_14538.pdf>.

30 International Finance Corporation, 'Stabilisation Clauses and Human Rights' (Research Project, International Finance Corporation, 11 March 2008) <http://www.ifc.org/ifcext/enviro.nsf/AttachmentsByTitle/p_StabilizationClausesandHumanRights/$FILE/Stabilization+Paper.pdf>.

> affecting the rights and economic benefits of TOTCO or of Shareholders as provided for in this Convention …

It is suggested in this report by Amnesty International that these stabilisation clauses can be invoked by the foreign investors to prevent Chad and Cameroon, as host states, from fulfilling some basic human rights obligations such as the right of the workers to health and a safe working environment.[31] For example, if the Chad government wished to require investors to comply with more stringent regulations to provide workers with a better work environment, it would be prevented by the stabilisation clause from doing so. To that extent, a conflict existed between the conduct required of the Chad government under the stabilisation clause and its obligations under international law. Such conduct would therefore be illegal under international law.

It could be argued that the Chad Government could absorb the costs of providing a better work environment for its workers and that would enable it to fulfil its international obligation without being in breach of the stabilisation clause. However, as pointed out by the recent International Finance Corporation study, having to pay monetary compensation to the investor for compliance with new laws would have the same deterring effect on host states.[32] In fact, in reality, it may be difficult for many developing countries to absorb the costs that would be incurred by new social or environmental legislation. Therefore, these stabilisation clauses may have the ultimate practical effect of causing the host state to breach their international human rights obligations. It is therefore possible for the conduct of the host state under a stabilisation clause to conflict with their international human rights obligations and hence become illegal under international law.

5 *Corruption Cases*

Contracts involving corrupt conduct of state officials could be another example of contracts involving illegal conduct under international law. For example, in *World Duty Free v Kenya*,[33] World Duty Free entered into a contract in 1989 with Kenya for the construction and operation of some duty free shopping complexes. In order to obtain the contract, the investor made a personal donation of US$2 million to the then incumbent President of Kenya in such circumstances, as later found by an ICSID tribunal, that the investor knew that it was a bribe. Subsequently, in 1998, following various allegations of illegal acts committed by the investor, the government of Kenya put the company under receivership and eventually took over the control of the company. The investor then brought an ICSID arbitration claiming against Kenya for breaches of the contract.

In the event, the Tribunal found that because bribery was against international public policy, the contract, being procured by bribery, was not enforceable.

31 Amnesty International, above n 29, 38.

32 International Finance Corporation, above n 30, 37.

33 *World Duty Free Company Ltd v The Republic of Kenya (Jurisdiction)* (ICSID Arbitral Tribunal, Case No ARB/00/7, 4 October 2006).

However, it seems that the conduct of the Kenyan government could have also been considered illegal under rules of international law against corruption. Kenya has signed and ratified the *United Nations Convention against Corruption* 2003,[34] under art 5 of which it is obliged to prevent acts of corruption. Corruption is also condemned by all national systems and, as recognised by the Tribunal in this case, its prohibition seems to be a general principle of law.[35] It is clear here that the conduct of the Kenyan President, attributable to Kenya, in concluding the contract with full knowledge that the corruption conflicted with the anti-corruption international obligations of Kenya, was illegal under international law.

Many other real or hypothetical examples similar to those described above can be cited to illustrate the reality or possibility of state contracts involving illegal conduct under international law. These cases typically involve a conflict between, on the one hand, a mandatory rule of international law imposing an international obligation on a party, mainly the host state, and, on the other hand, conduct required of, or carried out by, such a party under the contract. The case of mandatory dispute settlement provisions in BITs could be another example. These BITs require that investment disputes be resolved before one forum while the contracts between the investors and the host states may require such disputes to be resolved before another forum. Does such a conflict make those contracts illegal and if so, what are the consequences of such illegality? These issues will now be considered below.

B *When Is a State Contract Illegal under International Law?*

In some rare instances in the past where a state contract has been characterised as illegal under international law, the characterisation has often been based solely on the fact that the conduct of a party under the contract was illegal under international law. In other words, it has often been assumed that once the conduct under the contract is illegal, the contract itself is necessarily illegal under international law. For example, it can be recalled that the Tribunal in the *SPP v Egypt* case refused to award SPP the profits that would have been generated under the contract after the time the project became illegal under international law. In doing so, the Tribunal implicitly considered the contract illegal and void simply because the conduct to be carried out under it became illegal under international law. Another example can be found in the opinion of the Under-Secretary-General for Legal Affairs of the UN, provided to the Security Council, concerning the legality of the action of Moroccan authorities in concluding contracts with some foreign investors for oil exploration activities in Western Sahara.[36] Since 1979, Morocco had been the

34 *United Nations Convention against Corruption*, opened for signature 9 December 2003, 2346 UNTS 41 (entered into force 14 December 2005).

35 International Finance Corporation, above n 30, [157].

36 Hans Correl, Under-Secretary-General for Legal Affairs, *Letter Dated 29 January 2002 from the Under-Secretary-General for Legal Affairs, the Legal Counsel, Addressed to the President of the Security Council*, UN Doc S/2002/161 (12 February 2002).

administering power for the Western Sahara which was a Non-Self-Governing Territory. The question that the Security Council asked the Under-Secretary-General was whether the action of the Moroccan authority in concluding such contracts was illegal under international law. The Under-Secretary-General gave the opinion that such conduct would only be illegal under international law if it was conducted in disregard of the interest of the local people in the Western Sahara. At the end of his opinion, he stated:

> The conclusion is, therefore, that, while the specific *contracts* which are the subject of the Security Council's request are not in themselves illegal, if further exploration and exploitation activities were to proceed in disregard of the interests and wishes of the people of Western Sahara, they would be in violation of the principles of international law applicable to mineral resource activities in Non-Self-Governing-Territories.[37]

Whilst not perfectly clear, the above phrase seems to indicate a view by the Under-Secretary-General that if the conduct of the Moroccan authorities in performing the contracts was illegal, the contracts themselves would also be illegal. This is similar to the approach taken by the *SPP v Egypt* Tribunal. In a similar vein, as mentioned above, the Special Rapporteur of the Commission of Human Rights stated in an Annual Report to the UN General Assembly that contracts for using mercenary services were illegal.[38] This statement was solely based on his opinion that the use of mercenary services by states was illegal under international law.

Those conclusions reflect an assumption, apparently with little thought given to it, that if the conduct of the host state under the contract is illegal under international law, the contract itself will also be illegal. However, no rules of international law seem to support this proposition. In fact, such a proposition would be rather extraordinary because the host state, being in a position to create international law by entering into treaties or even making unilateral declarations, would be able to render the contract illegal through its own unilateral actions. For example, in *SPP v Egypt*, the illegality of the conduct of Egypt was brought about solely by its unilateral action in signing the *UNESCO Convention* and nominating the project site as a protected heritage. This happened after the conclusion of the contract and was therefore totally beyond the control of SPP. In that context, it would appear rather unfair for Egypt to have absolute discretion to determine the fate of a contract, and the position of the foreign investor under it, through its own unilateral actions. Indeed, this is precisely the danger that parties and tribunals attempt to avoid by applying international law to a contract. For that reason, it seems important that some factors should be taken into account before characterising a contract as illegal under international law. The contract should not be considered illegal merely because the conduct of the host state under it is illegal under international law.

37 Ibid 6 (emphasis in original).

38 Enrique Bernales Ballesteros, Special Rapporteur, *Report on the Question of the Use of Mercenaries as a Means of Violating Human Rights and Impeding the Exercise of the Right of Peoples to Self-determination*, 50th sess, Agenda Item 9, UN Doc E/CN.4/1994/23 (12 January 1994) [39].

So what is the rule of international law on this matter? As with other contractual issues in international law, the rules are not easy to find. No rules of customary international law are relevant. In terms of treaties, while they may proscribe certain conduct, they never stipulate the consequences for contracts involving such conduct. This is understandable as it would hardly occur to authors of treaties that the validity of offending contracts should be a matter regulated within the treaties. If it did ever occur to them, they would often leave it to national laws to regulate because contractual matters are traditionally considered an issue for national laws to govern. For example, the *United Nations Convention against Corruption* provides in art 34:

> With due regard to the rights of third parties acquired in good faith, each State Party shall take measures, in accordance with the fundamental principles of its domestic law, to address the consequences of corruption. In this context, State Parties may consider corruption a relevant factor in legal proceedings to annul or rescind a contract, withdraw a concession or other similar instrument or take any other remedial action.

At the same time, there are also no treaty rules that are appropriate to apply by analogy. In international law, treaties are not subject to a higher system of rules in the way a contract is subject to its governing law. Treaties themselves form part of international law and they are not governed by any superior legal system. There is no category of 'illegal treaties' in international law in the same way as one would have 'illegal contracts' in national laws. Treaties that may arguably bear some similarity are those which violate rules of *jus cogens* contemplated in art 53 of the *Vienna Convention on the Law of Treaties*[39] which provides:

> A treaty is void if, at the time of its conclusion, it conflicts with a peremptory norm of general international law. For the purposes of the present Convention, a peremptory norm of general international law is a norm accepted and recognised by the international community of States as a whole as a norm from which no derogation is permitted and which can be modified only by a subsequent norm of general international law having the same character.

Apart from the similarities between contracts and treaties mentioned earlier, the treaties contemplated under art 53 are also similar to contracts involving illegal conduct in two other ways. First, by conflicting with a rule of international law, the contract is in breach of a rule of 'higher normativity'[40] in the same way as a treaty conflicting with a peremptory norm of international law. These 'higher' rules serve as overriding rules and deprive the treaty and the contract of their legality to the extent of any conflict.[41] Secondly, the parties to the contract are not in a position to derogate from such rules by agreement, in the same way two

39 *Vienna Convention on the Law of Treaties*, opened for signature 23 May 1969, 1155 UNTS 331 (entered into force 27 January 1980) ('*Vienna Convention*').

40 Oscar Schachter, 'Entangled Treaty and Custom' in Yoram Dinstein (ed), *International Law at a Time of Perplexity: Essays in Honour of Shabtai Rosenne* (Martinus Nijhoff, 1989) 734.

41 Commentary, 'Commentaries on the Draft Articles on the Law of Treaties' (1966) 2 *Yearbook of the International Law Commission* 187, 261.

states cannot derogate from a peremptory rule of international law by way of a treaty. Therefore, it may be argued that a contract which contravenes a mandatory rule of international law should be treated in the same way as a treaty which breaches a rule of *jus cogens*.

However, it is submitted that art 53 of the *Vienna Convention* is not an appropriate analogy because it only contemplates a very narrow group of treaties that violate fundamental rules of international law such as the rule against slavery or the rule against unlawful use of force.[42] There is little doubt that any treaties or contracts that violate these fundamental rules should be void, but contracts involving illegal conduct under international law form a much larger category. As described earlier, these contracts may offend a diverse range of rules of international law, ranging from fundamental rules on human rights to technical rules concerning environmental standards. A stringent rule designed only for treaties which violate fundamental rules of *jus cogens* cannot be appropriately applied by analogy *en bloc* to contracts that breach rules of international law of varying nature and significance. Whilst it is understandable that a contract should be illegal for contravening a fundamental rule of international law, such as the rule against torture, it is hard to see why a contract should be illegal if it only technically violates a procedural rule, such as time limits, where the consequences are insignificant.

Thus, in the absence of directly applicable rules and rules applicable by analogy, one turns to seek a general principle of law. This must be done by examining a number of national legal systems, especially those with connections to the dispute. The outcome of this exercise therefore depends to some extent on which national legal systems are chosen for examination in a particular case. However, generally speaking, a tribunal should examine at least some systems representative of the main legal traditions in the world, including common law and civil law jurisdictions, but even that will be enough to reveal that there is little uniformity among national legal systems on this subject. The systems following the civil law tradition tend simply to consider illegal all contracts that contravene statutes and hence involve illegal conduct. For example, French law provides in arts 1131 and 1133 of the French Civil Code[43] that an obligation is without legal effect if it contravenes a statute.[44] German law states similarly in s 134 of its Civil Code[45] that a legal transaction which violates a statutory prohibition is void, unless stated otherwise by the statute itself. The Swiss Federal Code of Obligations[46] states in art 20 that a contract is void if it has an illegal object. In the same way, Chinese law stipulates in art 52 of the Contract Law 1999[47] that a contract is void for illegality where it contravenes a mandatory provision of any law.

42 Ibid 248.

43 *Code civil* [Civil Code] (France).

44 See also Nicholas, above n 2, 128.

45 *Bürgerliches Gesetzbuch* [Civil Code] (Germany).

46 *Schweizerisches Obligationsrecht* [Civil Code] (Swiss).

47 中华人民共和国合同法 [Contract Law of the People's Republic of China] (People's Republic of China) National People's Congress, 15 March 1999.

In contrast, the common law jurisdictions take a more flexible approach by requiring the court to consider a number of factors before concluding that a contract is illegal. Under English law, for example, where the statutes do not expressly declare an offending contract to be illegal, the court, in determining whether the contract is illegal, must consider factors such as the purpose of the statutes, the wilfulness of the breach, the public benefit in declaring the contract illegal and whether the illegality is central or merely incidental to the contract.[48] Australian law takes the same approach[49] and so do the US jurisdictions.[50] For example, the Supreme Court of Indiana listed the following factors to be taken into account in such a determination:

> (i) the nature of the subject matter of the contract … (ii) the strength of the public policy underlying the statute … (iii) the likelihood that refusal to enforce the bargain or term will further that policy … (iv) how serious or deserved would be the forfeiture suffered by the party attempting to enforce the bargain … (v) the parties' relative bargaining power and freedom to contract.[51]

The approaches between civil law and common law systems are therefore quite different. However, at least an overlap exists between them in that contracts that are considered illegal under common law systems will also be considered illegal under civil law systems. In other words, the contracts that are considered illegal in common law systems form a subset of those considered illegal in civil law systems. To the extent of that overlap, a general principle of law can be said to exist because the same legal position is obtained no matter which national law is applied. Therefore, if a contract passes the test for illegality in a common law system (which takes into account the factors mentioned above), then it can be said to be illegal under a general principle of law. An example is the contract in *Sandline* which contravened a rule of customary international law on the use of mercenary services (assuming such a rule exists). In light of the direct conflict between the contract and the rule of international law, the importance of such a rule and the seriousness of the possible consequences, the contract would likely be considered illegal in a common law system and hence illegal under a general principle of law. Similarly, the contract in *SPP v Egypt* would also likely be deemed illegal in this way due to the direct conflict between the contract and the prohibition in the *UNESCO Convention* regarding the protection of the pyramid area, probably except where it could be proved that Egypt created the international obligations merely to avoid its contract with SPP. By way of another example, a jurisdiction clause in a contract which conflicts with a mandatory jurisdiction clause in a BIT is also likely to fall within this group. Given the direct conflict between the contract and the BIT, the importance of the mandatory

48 *St John Shipping Corporation v Joseph Rank Ltd* [1957] 1 QB 267; *Archbolds (Freightage) Ltd v Spanglett Ltd* [1961] 1 QB 374; Ewan McKendrick, *Contract Law* (Palgrave, 7th ed, 2007) 330; Beale, above n 2, 1022.

49 *Yango Pastoral Co v First Chicago Bank* (1978) 139 CLR 410.

50 *Fresh Cut v Fazli*, 650 NE 2d 1126 (Ind, 1995); E Allan Farnsworth, *Farnsworth on Contracts* (Aspen, 3rd ed, 2004) vol 2, 70; American Law Institute, *Restatement (Second) of Contracts* (1981) §178.

51 *Fresh Cut v Fazli*, 650 NE 2d 1126, 1130 (Ind, 1995).

dispute resolution mechanism in the BIT and the furtherance of the objectives of the BIT in observing this mandatory jurisdiction requirement, the conflicting jurisdiction clause in the contract is likely to be considered illegal under common law systems and thus illegal under a general principle of law.

However, not all contracts fall within this category. Many other contracts, whilst also involving a conflict with a rule of international law, may not pass this test. An example is the concession contract in *Aguas del Tunari v Bolivia* or the stabilisation clause in the contract between ExxonMobil and the Chad Republic. As mentioned above, there is nothing wrong with these contracts or contractual terms per se. However, during the course of their performance, there may be situations, which can be hard to determine, where the performance of the contract may have the effect of conflicting with human rights obligations of the host state. Such conflict seems rather incidental to the contract and therefore may not pass the illegality test in common law jurisdictions. If so, such contracts cannot be held illegal pursuant to a general principle of law. But that is not the end of the process. Because no general principle of law exists for assessing whether these contracts are illegal, the tribunal will need to apply a relevant national legal system to determine this question. The legality of the contract at this point becomes uncertain because it depends on which national law the tribunal applies in the end. If the tribunal applies a national law involving the common law approach, then the contract will not be considered illegal because it has not passed the common law test for illegality. On the other hand, if the tribunal applies a civil law style system, the contract will be considered illegal merely because it conflicts with a mandatory rule of international law, regardless of the considerations mentioned above.

As a matter of policy, a tribunal should not consider a contract illegal merely because it involves a conflict with a rule of international law. Such a characterisation of the contract should not be made lightly. In reality, illegality is often raised by the host state as a defence to a claim for breach of contract. Declaring the contract to be illegal in such a case often means releasing the host state from the commitments it has voluntarily undertaken to the investor. The potential unfairness to the investor could be serious where it has made a substantial investment in the territory of the host state. Such possible unfairness must be weighed against other factors such as the public interest of the host state and the international community as a whole. This balancing exercise is only possible where the tribunal is authorised, in considering whether a contract is illegal, to take into account different factors including: the knowledge of the investor of the illegality at the time the contract is entered into, whether the investor assumed the risk of such illegality, whether the illegality is serious, whether the illegality is central or incidental to the contractual obligation in question and so on. Therefore, where the tribunal has discretion as to the choice of law on this question, it should choose a common law system for the reasons mentioned above. However, it is possible that under the relevant conflict of laws rules, a tribunal will be obliged to apply a civil law style system. In that case, it will be obliged to consider the contract illegal even if it only involves an illegality which is rather incidental and not so serious.

In summary, the above discussions show the difficulties and uncertainty involved in identifying and applying a general principle of law to an issue in a state contract. On the issue of whether a contract is illegal due to a conflict with a rule of international law, a general principle can be identified only for cases where a serious and direct conflict exists between the contract and international law. However, for many other contracts, no general principle of law exists and the legality of those contracts must be determined under a national law, which may or may not find the contracts illegal. A choice of international law as the governing law of the contract thus makes the fate of the contract rather uncertain in this case. Whether it will be considered illegal depends on what national law the tribunal applies in the end. This can be hard to predict in situations where the tribunal has broad discretion under relevant choice of law rules.

Assuming a tribunal has considered a contract illegal under international law, it will then need to consider the final question, which is what consequences flow from that? Once again, a general principle of law must be identified and further uncertainty follows. This is described below.

C *Consequences for Illegal State Contracts under International Law*

Once a tribunal has decided that a contract is illegal under international law, it will need to consider what consequences flow from such illegality. Again, no directly applicable rules of international law exist. Occasionally, one finds a rule of international law that may apply by analogy. For example, art 50 of the *Vienna Convention* provides that where one state has procured the conclusion of a treaty through the corruption of the representative of the other state, the latter may invoke the act of corruption to invalidate its consent to the treaty. In other words, a treaty is voidable and the injured party may choose either to perform the treaty or to revoke it.[52] This article seems appropriate to apply by analogy to state contracts that are procured by corruption. Once the host state discovers that the investor has bribed the state representative in order to obtain the contract, the host state may choose either to continue to perform the contract or to rescind it on the ground of the corruption.

However, it is rare to find a rule of international law that may apply by analogy. In the case of most illegal state contracts, a tribunal will have to identify, if possible, and apply a general principle of law to determine the consequences of the illegality for the contract. As with the question of when a contract is considered illegal under international law, the general principle of law that may be identified depends on the national systems that the tribunal chooses to examine. However, the general position amongst national legal systems seems to be that all illegal contracts are unenforceable. National courts will not enforce an illegal contract

52 Commentary, 'Commentaries on the Draft Articles on the Law of Treaties' (1966) 2 *Yearbook of the International Law Commission* 187, 245.

and thereby facilitate an illegal act.[53] However, at the same time, a difference exists among national legal systems regarding the rights of the innocent party who is not involved in or aware of the illegality. Some legal systems, mostly following civil law traditions, may deny all parties the right to bring any action under the contract. However, common law systems tend to be more flexible and may allow the innocent party to recover money paid or even obtain damages for a breach of contract.[54] In this respect, it is interesting to note that *Introduction to Principles of European Contract Law*,[55] which was drafted to embody the common principles of contract law in Europe, adopts a very flexible approach. It provides in s 15:102(2) that where a contract contravenes a mandatory rule of law, a tribunal may declare that the contract has full effect, some effect, no effect or is subject to modification, taking into account the following:

(a) the purpose of the rule which has been infringed;

(b) the category of persons for whose protection the rule exists;

(c) any sanction that may be imposed under the rule infringed;

(d) the seriousness of the infringement;

(e) whether the infringement was intentional; and

(f) the closeness of the relationship between the infringement and the contract.

Thus, a general principle of law seems to exist to the effect that an illegal contract is unenforceable. However, beyond that, it is uncertain whether an innocent party will be able to claim against the guilty party for, for example, restitution or even damages. As no general principles of law exist on this question, a tribunal will again need to turn to the applicable national law for the solution. Depending on the national law that is applied, the innocent party, often the investor, may claim restitution or even damages against the guilty party which is often the host state. The tribunal may even have broader discretion to order other forms of relief if the national law adopts a position similar to that in *Introduction to Principles of European Contract Law*. In this respect, it is useful to mention *SPP v Egypt*, in which the illegality of the contract was brought about solely by the unilateral action of Egypt. Therefore, SPP could be said to be the innocent party. In this case, the Tribunal allowed SPP to claim recovery of its original investment and its entitlement to the profits from the project up to the time the illegality occurred.

53 For French law: *Code civil* [Civil Code] (France) arts 1131–3; Nicholas, above n 2, 133. For German law: *Bürgerliches Gesetzbuch* [Civil Code] (Germany) § 134. For Chinese law: 中华人民共和国合同法 [Contract Law of the People's Republic of China] (People's Republic of China) National People's Congress, 15 March 1999, art 52(v). For English law: *Archbolds (Freightage) Ltd v Spanglett Ltd* [1961] 1 QB 374; Beale, above n 2, 941; Beatson, above n 2, 397. American Law Institute, *Restatement (Second) of Contracts* (1981) §178; Farnsworth, above n 50, 68–82.

54 *St John Shipping Corporation v Joseph Rank Ltd* [1957] 1 QB 267; *Archbolds (Freightage) Ltd v Spanglett Ltd* [1961] 1 QB 374; Edwin Peel, *The Law of Contract* (Sweet & Maxwell, 12th ed, 2007) 529; Farnsworth, above n 50, 82–5.

55 The Commission on European Contract Law, *Introduction to the Principles of European Contract Law* (1999) available at <http://www.cisg.law.pace.edu/cisg/text/peclcomments.html>.

The Tribunal did not specify the legal basis for this decision. As SPP was the innocent party, it seems reasonable that it was entitled to recover its original investment. However, it seems unclear why SPP could recover profits from the contracts only up to the time of the illegality. Unless this decision was based upon a national legal system which denies the right of the innocent to claim any benefits from the contract, this decision would be hard to justify. The decision would have been more convincing if the legal basis for it had been specified.

The above exercise demonstrates the difficulties and uncertainty involved in identifying and applying general principles of law to state contracts governed by international law. Rules of contract law in different national systems may vary greatly. Extracting a general principle from them may be difficult or impossible. As useful as they may be where there are no directly applicable rules or rules applicable by analogy, the availability of general principles of law is limited. Therefore, resort to a national law is inevitable in a number of cases. In those cases, there will be some uncertainty in predicting the final outcome of the legal problems arising out of the contract because it will depend on what national law the tribunal applies to the contract in the end. This confirms that it is useful for the parties to choose a national law to govern the contract in addition to international law. That will save the tribunal the need to determine the national law that applies and avoid the uncertainty involved in predicting the legal outcome, as mentioned above.

III ILLEGALITY UNDER THE LAW OF THE HOST STATE

In practice, an issue that is often raised concerning the legality of a state contract is that it is illegal under the law of the host state. This is often raised by the host state, usually as a defence to a claim by the investor for a breach of contract. Examples of such cases are abundant in the international investment jurisprudence, including ICSID and other such bodies' cases.[56] In such a case, if the governing law of the contract is the law of the host state, the illegality defence will often succeed and bar the claim of the investor. If the contract is governed by the law of a third country, the same outcome may also be obtained because, under the comity of nations principle, the law of that country may give effect to the mandatory legal rules of the host state, the place where the contract is performed. In that case, a tribunal applying the national governing law of the contract may

56 *Revere Copper and Brass v Overseas Private Investment Corporation* (1978) 56 ILR 258; *SPP v Egypt* (1983) 3 ICSID Rep 46; *Sandline* (1998) 117 ILR 552; *Fraport AG Frankfurt Airport Services Worldwide v Republic of the Philippines (Award)* (ICSID Arbitral Tribunal, Case No ARB/03/25, 16 August 2007); *Inceysa Vallisoletana SL v Republic of El Salvador (Award)* (ICSID Arbitral Tribunal, Case No ARB/03/26, 6 August 2006); *Tokios Tokeles v Ukraine (Jurisdiction)* (ICSID Arbitral Tribunal, Case No ARB/02/18, 29 April 2004).

refuse to enforce the contract because it is illegal in the place of its performance.[57] Therefore, an illegality under the law of the host state is likely to have important consequences for the contract if it is governed by a national law.

But where the contract is governed by international law, the position is fundamentally different. As a general rule, the legality of a contract governed by international law is to be determined solely by reference to rules of international law and the rules of any domestic law are irrelevant.[58] International law will not recognise illegality under such law as vitiating the contract. Put another way, under international law, the host state may not invoke its internal law to deny its contractual obligations. This is an important feature of international law and an important reason behind its choice as the governing law of many state contracts.

However, this important rule of international law may be rendered inapplicable by provisions in BITs which require compliance with the domestic law of the host state. These BIT provisions may have the effect of transforming an illegality under the law of the host state into an illegality under international law. In other words, a failure to comply with the domestic law of the host state could constitute a breach of international law, rendering the contract illegal and possibly void under international law. If so, this will have the effect of removing one of the most attractive advantages of international law as the governing law of the contract. This issue will be examined further below. However, first, it will be necessary to describe the general rule that host states cannot invoke their internal law to avoid contractual obligations owed to investors.

A *Host States Cannot Invoke Internal Law as a Defence*

It is a well-settled rule of international law that a state may not invoke its internal law to deny an international obligation.[59] Many tribunals have applied this rule in state contract disputes to hold that a host state cannot invoke its internal law

57 Under English law, this is the rule in *Ralli Bros v Compania Naviera Sota y Aznar* [1920] 2 KB 287, as confirmed in many subsequent cases such as *De Beeche v The South American Stores* [1935] AC 148, 156; *The King v International Trustee for the Protection of Bondholders AG* [1937] AC 500, 519; *Zivnostenska Banka National Corporation v Frankman* [1950] AC 57, 71; *Lemenda Trading Co Ltd v African Middle East Petroleum Co Ltd* [1988] QB 448, 454; *Libyan Arab Foreign Bank v Bankers Trust Co* [1989] 1 QB 728, 743. For commentary, see Lawrence Collins (ed), *Dicey, Morris & Collins on The Conflict of Laws* (Sweet & Maxwell, 14th ed, 2006) 1594–7; Beale, above n 2, 955. For other European jurisdictions governed by the *Rome Convention*, see *Convention on the Law Applicable to the Contractual Obligations Opened for Signature in Rome on 19 June 1980 (80/934/EEC)* [1980] OJ L 266/1, art 7.

58 Hop Dang, 'The Applicability of International Law as the Governing Law of State Contracts' (2010) 17 *Australian International Law Journal* 133.

59 Brownlie, above n 7, 34–6; Commentary, 'Draft Articles on Responsibility of States for Internationally Wrongful Acts with Commentaries' (2001) 2 *Yearbook of the International Law Commission* 31, 59; Theodor Meron, 'International Responsibility of States for Unauthorised Acts of Their Officials' (1957) 33 *British Yearbook of International Law* 85; David Harris, *Cases and Materials on International Law* (Sweet & Maxwell, 6th ed, 2004) 67–8; Report, 'Report of the International Law Commission on the Work of Its 27th Session, 5 May–25 July 1975' (1975) 2 *Yearbook of the International Law Commission* 47; Malcolm Shaw, *International Law* (Cambridge University Press, 5th ed, 2003) 124–7. See also *Texaco Overseas Petroleum Company v Libyan Arab Republic* (1978) 53 ILR 389, 480–1; *Vienna Convention* art 27.

to deny a contractual obligation owed to a foreign investor. Examples can be found in cases such as *Revere*,[60] *Sandline* and so on.[61] In *Revere*, the issue for the tribunal was whether a 'no further tax' contractual obligation of Jamaica was binding on it. It was argued that this 'no further tax' obligation was not binding on Jamaica because under Jamaican law, as held by the Supreme Court of Jamaica, this obligation was null and void for fettering the discretion of the Jamaican government. The tribunal held that the contract was governed by international law and, on that basis, held that the 'no further tax' obligation was binding on Jamaica. As the basis for this decision, the tribunal quoted[62] the following statement by the International Law Commission:

> The principle that a State cannot plead the provisions (or deficiencies) of its constitution as ground for the non-observance of its international obligations … is indeed one of the great principles of international law, informing the whole system and applying to every branch of it …[63]

Similarly, in the *Sandline* arbitration, PNG argued that the contract was not binding on it because it contravened the internal law of PNG. Assuming that the contract contravened the internal law of PNG, the tribunal, holding that it could apply international law, rejected this argument by PNG as follows: 'a state cannot rely upon its own internal laws as the basis for a plea that a contract concluded by it is illegal'.[64]

This is a well-established rule of customary international law as applicable to state contracts. It was suggested by Mann in the early days[65] and has received support of many authors since then.[66] This rule evidently favours investors by insulating the contract from any legal problems that might arise from the domestic law of the host state. This is a main reason why investors prefer to choose international law for their state contracts in many cases. By choosing international law, investors hope to 'delocalise' the contract and prevent the host state from raising their internal law to repudiate the contract. On the other hand, host states naturally see this rule as highly undesirable. It allows state officials, investors and even tribunals to circumvent the law of the host state simply by choosing international law as the governing law of the contract. Government officials may exceed their

60 *Revere Copper and Brass v Overseas Private Investment Corporation* (1978) 56 ILR 258 ('*Revere*').

61 *Shufeldt Claim (United States of America v Guatemala)* (1930) 2 RIAA 1079; *Tinoco Arbitrations (Great Britain v Costa Rica)* (1923) 1 RIAA 371; *Pomeroy v The Islamic Republic of Iran* (1983) 2 IUSCTR 372; *Benteler v Belgium* (1985) 8 European Commercial Cases 101; *Company Z v State Organisation ABC* (1983) 8 YCA 94; *SPP v Egypt* (1983) 3 ICSID Rep 46.

62 *Revere* (1978) 56 ILR 258, 273–86.

63 Report, 'Third Report on State Responsibility' (1971) 2 *Yearbook of the International Law Commission* 199, 227.

64 *Sandline* (1998) 117 ILR 552, 561.

65 F Mann, 'The Proper Law of Contracts Concluded by International Persons' (1959) 35 *British Yearbook of International Law* 34, 47.

66 Christopher Curtis, 'The Legal Security of Economic Development Agreements' (1988) 29 *Harvard International Law Journal* 317, 342; Jan Paulsson, 'May a State Invoke Its Internal Law to Repudiate Its Consent to International Commercial Arbitration?' (1986) 2 *Arbitration International* 90; Veijjo Heiskanen, 'May a State Invoke Its Domestic Law to Evade its International Obligations?' (2005) 2(5) *Transnational Dispute Management* 1.

statutory powers by signing contracts contravening internal law and yet create binding contractual obligations for the host state. Additionally, an investor may violate, or collude with a state representative in violating, the law of the host state and safely hide behind the shield of a choice of international law as the governing law of the contract. These legitimate concerns seem to lie behind many references in BITs which require compliance with the domestic law of the host state. It is possible that these references have been inspired by an attempt of the host states to displace the above rule of international law. This issue will be examined below.

B *References to Domestic Law in BITs*

If one ever found a BIT provision expressly requiring that contracts between foreign investors and the host state must comply with the domestic law of the host state, such a BIT provision would constitute a mandatory rule of international law that state contracts under such a BIT must comply with the law of the host state. In such a case, if a state contract breaches a domestic law of the host state, it also breaches this mandatory rule in the BIT, a rule of international law, and hence is illegal under international law. Thus, the BIT has the effect of transforming an illegality under the domestic law of the host state into an illegality under international law, which vitiates the contract and makes it illegal under international law.

However, such a BIT does not seem to exist in practice. BITs, like other treaties, rarely deal directly with validity of contracts which contravene their terms. However, there are other BIT provisions which may produce the same effect through different words. First, some BITs require investment activities to comply with the law of the host state. Second, they may authorise BIT arbitral tribunals to apply the domestic law of the host state. Third, BITs define investments by referring to those 'in accordance with the law of the host state'. This section will now examine these BIT provisions in turn to see if they have the same effect as the hypothetical BIT provision mentioned above.

1 *Investments to Comply with the Law of the Host State*

A number of BITs contain express provisions which require that investment activities by investors must comply with the law of the host state. For example, art 10 of the BIT between Korea and India provides: 'All investments shall be consistent with this Agreement and be in accordance with the laws in force in the territory of the Contracting Party in which such investments are made'.[67] In different words, art 11 of the BIT between Egypt and India provides: 'Except as otherwise provided in this Agreement, all investments shall be governed by the laws in force in the territory of the Contracting Party in which such investments

67 *Bilateral Investment Treaty between the Republic of Korea and the Republic of India*, signed 26 February 1996, ICSID Investment Treaties (entered into force 7 May 1996) art 10.

are made'.[68] Alternatively, art 10 in the BIT between Singapore and Vietnam provides:

> For the avoidance of any doubt, it is declared that all investments shall, subject to this Agreement, be governed by the laws in force in the territory of the Contracting Party in which such investments are made.[69]

The first example above, the BIT between Korea and India, explicitly requires all investment activities to comply with the law of the host state by stating 'all investments shall … be in accordance with the laws in force' in the host state. The other two examples are slightly less explicit but have the same effect by requiring the investment to be 'governed by' the law of the host state. The essence of all these BIT provisions, expressed in different words, is the same — the investment activities by the investor must comply with the law of the host state.

Sometimes, this requirement appears in a less conspicuous position such as in art 1(1) of the BIT between Egypt and Cyprus, which needs to be quoted in full:

> The term 'investments' shall comprise every kind of asset and in particular, though not exclusively:
>
> (a) moveable and immoveable property as well as any other property rights in respect of every kind of asset;
>
> (b) rights derived from shares, bonds and other kinds of interests in companies;
>
> (c) title to money, good will and other assets and to any performance having economic value;
>
> (d) rights in the field of intellectual property, technical processes and know how.
>
> *These investments shall be made in compliance with the laws and regulations and any written permits that may be required thereunder of the Contracting Party in the territory of which the investment has been made*.[70]

On one interpretation, the legality requirement in the emphasised paragraph is merely part of the definition of 'investment', which is commonly seen in BITs (this is discussed in more detail below). In that sense, only investments that comply with the law of the host state fall under the ambit of the BIT. Apart from that, this provision does not impose any requirements in respect of the investments. However, a more plausible interpretation, which is more consistent with the plain

68 *Bilateral Investment Treaty between the Arab Republic of Egypt and the Republic of India for the Promotion and Reciprocal Protection of Investments*, signed 9 April 1997, ICSID Investment Treaties (entered into force 22 November 2000) art 11. BITs between India and Hungary, and Switzerland and Indonesia contain identical terms.

69 *Bilateral Investment Treaty between the Republic of Singapore and the Socialist Republic of Vietnam*, signed 29 October 1992, ICSID Investment Treaties (entered into force 25 December 1992) art 10. BITs between Cambodia and Singapore and between Uganda and Eritrea contain identical terms.

70 *Bilateral Investment Treaty between the Arab Republic of Egypt and the Republic of Cyprus*, signed 21 October 1998, ICSID Investment Treaties (entered into force 9 June 1999) art 1(1) (emphasis added).

meaning and structure of this provision, is that this constitutes a standalone requirement that all the investments as defined generally and particularised in paragraphs (a), (b), (c) and (d) must be made in compliance with the domestic law of the host state. This interpretation is supported by the fact that in many other BITs that Egypt has entered into,[71] where the BIT is meant to cover only investments that are lawful, the phrase 'in accordance with the law of the host state' appears in the opening paragraph of the definition of 'investment', as commonly done in many BITs. Therefore, this emphasised paragraph should be construed as having the effect of requiring that all investments comply with the law of the host state.

So what do these provisions mean for our purposes? On one view, they are merely statements of the obvious: investment activities carried out in the territory of the host state naturally must comply with the law of the host state. For example, a bidding or construction process must comply with local bidding or construction regulations. Environmental matters must be in accordance with local regulations on environmental protection. These requirements are stipulated in the domestic law of the host state and, by stating that they must be complied with, these BIT provisions do not create any additional requirements. As the investor must comply with such regulations in any event, these BIT provisions seem to be statements of political acknowledgement, rather than substantive legal rules imposing any real obligations.

However, from a legal point of view, as practically obvious as they may be, these BIT provisions have the effect of transforming the requirements of domestic law into requirements of international law. There is now a requirement under international law, by virtue of these BIT provisions, that investments under the scope of these BITs must comply with the law of the host state. If an investment fails to comply with the law of the host state, it is considered illegal, not only under the law of the host state, but also under international law. This is similar to the reasoning applicable to umbrella clauses in BITs. Umbrella clauses are those which require host states to perform undertakings they have given to foreign investors. For example, the contract in *SGS v The Philippines*[72] contained the following umbrella clause: 'Each Contracting Party shall observe any obligation it has assumed with regard to specific investments in its territory by investors of the other Contracting Party'.[73]

It was held by the Tribunal in that case,[74] and it is now widely accepted,[75] that these umbrella clauses have the effect of constituting an international obligation of the host state to comply with the undertakings it has given to investors. A

71 See, eg, BITs between Egypt and Chile, China, Botswana, Georgia, Mauritius and Vietnam.

72 *SGS Société Générale de Surveillance SA v Republic of The Philippines (Jurisdiction)* (2003) 8 ICSID Rep 515.

73 Ibid.

74 Ibid.

75 Crawford, above n 6; Zachary Douglas, 'The Hybrid Foundations of Investment Treaty Arbitration' (2003) 64 *British Yearbook of International Law* 151; Christoph Schreuer, 'Calvo's Grandchildren: The Return of Local Remedies in Investment Arbitration' (2005) 4 *The Law and Practice of International Courts and Tribunals* 1.

failure by the host state to comply with such undertakings constitutes a failure by them to comply with a mandatory rule of international law. Similarly, the BIT provisions considered here, which require the investment to comply with the domestic law of the host state, should also be regarded as giving rise to an international obligation, particularly of the investor, to comply with the domestic law of the host state. Such an obligation was recognised by the Tribunal in the *Fraport* arbitration:[76]

> As for policy, BITs oblige governments to conduct their relations with foreign investors in a transparent fashion. Some reciprocal if not identical obligations lie on the foreign investor. One of those is the obligation to make the investment in accordance with the host state's law. … Respect for the integrity of the law of the host state is also a critical part of the development and a concern of international investment law.[77]

This means that a breach by the investor of the domestic law of the host state in carrying out the investment is considered a breach of international law, ie the BIT, and hence is an illegal act under international law. Conduct of the investor that is illegal under the law of the host state is thus transformed into illegal conduct under international law. As discussed earlier, this illegality may render the contract itself illegal under international law. On the basis of this BIT provision, the host state is able to invoke illegality under its domestic law to allege that the contract is illegal and void under international law. In other words, the BIT gives effect to the domestic law of the host state. Thus illegality under the domestic law of the host state has an effect on the international plane. This was also recognised by the *Fraport* Tribunal:

> The Tribunal cannot agree, as a matter of law, with the Claimant's contention that '[e]ven if there could be said to be an issue as to whether the Philippines laws were complied with … it could be of only municipal, not international legal significance'. This interpretation, if accepted, would deprive a significant part of the ordinary words of a treaty of any meaning and effect. The BIT is, to be sure, an international instrument but its Article 1 and 2 and ad Article 2 of the Protocol effect a *renvoi* to national law, a mechanism which is hardly unusual in treaties and, indeed, occurs in the [ICSID] Washington Convention. A failure to comply with the national law to which a treaty refers will have an international legal effect.[78]

These BIT provisions therefore create an exception to the general rule of international law that a host state cannot invoke illegality under its own law in order to refuse to perform a contract with foreign investors. These BIT provisions are certainly welcomed by capital importing states because they enable them

76 *Fraport AG Frankfurt Airport Services Worldwide v Republic of the Philippines (Award)* (ICSID Arbitral Tribunal, Case No ARB/03/25, 16 August 2007) ('*Fraport*').

77 Ibid [402].

78 Ibid [394]. These words are appropriate here, notwithstanding that they refer to a different type of BIT provision (emphasis in original).

to retain some control, through their domestic law, over the contract and the investment. On the other hand, such BIT provisions would seem undesirable to capital exporting states and their investors. With these BITs, a choice of international law now no longer has the attractiveness of allowing the parties to 'delocalise' the contract. If the contract is ever 'delocalised' by a choice of international law as the governing law of the contract, these BIT provisions have the effect of 'relocalising' it.

2 *BIT Tribunals Authorised to Apply Domestic Law of the Host State*

This is a common BIT provision, which appears in 24 out of the 100 BITs surveyed for the purposes of this paper. It authorises BIT tribunals to apply the domestic law of the host state in resolving disputes between investors and host states. It is necessary to consider this provision because it seems possible that a BIT tribunal may, by applying the domestic law of the host state, refuse to enforce a contract on the grounds that it contravenes the law of the host state, notwithstanding that the contract is governed by international law. If so, that would be another exception to the general rule of international law referred to above.

A close look at these BIT provisions shows that they in fact authorise BIT tribunals to apply the domestic law of the host state, often in addition to rules of international law. For example, art 8(4) of the BIT between the UK and Vietnam provides:

> The arbitral tribunal constituted under paragraphs (2) and (3) above shall reach its decisions on the basis of the domestic law of the Contracting Party in whose territory the investment in question is situated (including its rules on the conflict of laws) and the rules of international law (including this Agreement) as may be applicable.[79]

Alternatively, art 11(4) of the BIT between Chile and Turkey provides:

> The arbitral tribunal shall decide in accordance with the provisions of this Agreement, the laws of the Contracting Party involved in the dispute, including its rules on conflict of laws, the terms of any specific agreement concluded in relation to such an investment and the relevant rules and principles of international law.[80]

Faced with a contract illegal under the law of the host state, the issue for a BIT tribunal here is whether: (a) to apply the law of the host state and refuse to enforce the illegal contract; or (b) to apply international law to disallow the host state from invoking its internal law to refuse to perform the contract. In other words, the issue here is whether the BIT tribunal should apply domestic law or

79 *Bilateral Investment Treaty between the United Kingdom of Great Britain and Northern Ireland and the Socialist Republic of Vietnam*, signed 1 July 2002, ICSID Investment Treaties (entered into force 1 July 2002) art 8(4).

80 *Bilateral Investment Treaty between the Republic of Chile and the Republic of Turkey*, signed 21 August 1998, ICSID Investment Treaties (not yet in force) art 11(4).

international law in the event of a conflict between the two. Unfortunately, these BIT provisions do not specify an order of priority between the law of the host state and international law. Therefore, there is no guidance for the tribunal as to which law to apply in the event of inconsistency between them, as in the case being considered here.

On one view, the BIT tribunal should have the discretion to apply whichever law it considers applicable. In other words, it may choose to apply the law of the host state if it considers that appropriate. This can be analogised to the example of the Iran US Claims Tribunal ('IUSCT'), which is vested with wide powers with respect to choice of law under art 5 of the *Algiers Declaration*:[81]

> The Tribunal shall decide all cases on the basis of respect for law, applying such choice of law rules and principles of commercial and international law as the Tribunal determines to be applicable, taking into account relevant usages of the trade, contract provisions and changed circumstances.

The IUSCT has exercised such wide powers and even applied to contracts a law different from that chosen by the parties.[82] Therefore, it could be argued that a BIT tribunal here also has a similar discretion.

However, the language in art 5 of the *Algiers Declaration* is very different from the language in these BITs. Article 5 expressly authorises the IUSCT to apply any rules of law, international law included, that it 'determines to be applicable'. In other words, the IUSCT is given discretion to determine which rule is applicable and then to apply it. The BITs considered here do not give the same discretion to BIT tribunals. On the contrary, they are silent regarding which rule the BIT tribunals are authorised to apply in the event the domestic law of the host state conflicts with international law. In fact, the choice of law provision in these BITs is similar to ambiguous choice of law clauses in contracts, which refer to both the law of the host state and international law without specifying which one is to prevail in the case of inconsistency. It is also similar to the second sentence in art 42(1) of the *ICSID Convention*,[83] which requires the application of the law of the host state and international law without providing which one is to prevail in case of a conflict. It is suggested that in these cases, where the law of the host state and international law conflict, the tribunal should declare such a choice of law clause inoperative and rely on the choice of law rules binding upon the tribunal in the circumstances. It seems that BIT tribunals under the BITs considered here should also do the same.

Therefore, with this type of BIT provision, depending on how the tribunal may be directed by the relevant choice of law rules, it may apply the rules of international

81 *Declaration of the Government of the Democratic and Popular Republic of Algeria concerning the Settlement of Claims by the Government of the United States of America and the Government of the Islamic Republic of Iran*, signed 20 January 1981, 20 ILM 223, art 5 ('*Algiers Declaration*').

82 *CMI International Inc v Iran (Award)* (1983) 4 Iran–US CTR 263; *Housing and Urban Services International Inc v Iran (Award)* (1985) 9 Iran–US CTR 313.

83 *Convention on the Settlement of Investment Disputes between States and Nationals of other States*, opened for signature 18 March 1965, 575 UNTS 159 (entered into force 14 October 1966).

law or the law of the host state. If the tribunal is directed to apply the law of the host state, it will declare the contract illegal. In effect, in this case, the host state will be able to invoke its internal law to avoid the contract. However, that is a consequence of the choice of law made by the tribunal, rather than the effect of the BIT itself. In other words, a BIT in this category does not create an exception to the general rule that a state cannot invoke its internal law to refuse to perform a contract governed by international law.

3 *Investments Defined as Made 'in Accordance with the Law of the Host State'*

It seems to be common practice[84] for BITs to limit the scope of their protection to investments that are made in accordance with the law of the host state. This may be done by inserting the phrase 'in accordance with the law of the host state' in some BIT provisions, most typically in the definition of 'investment'. For example, art 1 of the BIT between Germany and the Philippines, considered in *Fraport*, provides:

> The term 'investment' shall mean any kind of asset admitted in accordance with the respective laws and regulations of either Contracting State and more particularly though not exclusively:
>
> (a) moveable and immoveable property as well as …[85]

Article 1(1) of the BIT between Ukraine and Lithuania, the subject of the *Tokios v Ukraine* arbitration,[86] defines 'investment' as 'every kind of asset invested by an investor of one Contracting Party in the territory of the other Contracting Party in accordance with the laws and regulations of the latter …'[87]

Alternatively, the phrase 'in accordance with the law of the host state' may appear in the protection provision, as in art 3 of the BIT between El Salvador and Spain, considered in the *Inceysa v El Salvador* arbitration:[88]

> Each Contracting Party shall protect in its territory the investments made in accordance with its legislation of investors of the other Contracting Party …[89]

Or, in the scope provision, as in art 11 of the BIT between Austria and Chile:

> This Agreement shall apply to investments in the territory of one Contracting Party made in accordance with its legislation prior to or after

84 Christoph Schreuer, *The ICSID Convention: A Commentary* (Cambridge University Press, 2001) 103.

85 *Bilateral Investment Treaty between the Republic of Philippines and the Federal Republic of Germany*, signed 18 April 1997, ICSID Investment Treaties (entered into force 2 February 2000) art 1.

86 *Tokios Tokeles v Ukraine (Jurisdiction)* (ICSID Arbitral Tribunal, Case No ARB/02/18, 29 April 2004).

87 *Bilateral Investment Treaty between Ukraine and The Republic of Lithuania*, signed 8 February 1994, ICSID Investment Treaties (entered into force 6 March 1995) art 1(1).

88 *Inceysa Vallisoletana SL v Republic of El Salvador (Award)* (ICSID Arbitral Tribunal, Case No ARB/03/26, 6 August 2006).

89 *Bilateral Investment Treaty between the Republic of El Salvador and the Kingdom of Spain*, signed 14 February 1995, ICSID Investment Treaties (entered into force 20 February 1996) art 3.

> its entry into force of the Agreement, by investors of the other Contracting Party.[90]

In the survey of 100 BITs by this author, almost 70 per cent contained this 'in accordance with the law of the host state' requirement, in some shape or form. Its purpose, as noted by the tribunal in *Salini v Morocco*, is to 'prevent the Bilateral Treaty from protecting investments that should not be protected particularly because they would be illegal'.[91] Therefore, if the investment is illegal under the domestic law of the host state, it will not be protected under the BIT and a BIT tribunal may decline jurisdiction in these cases, as was done in the *Fraport* and *Inceysa* arbitrations.[92]

But what does that mean for a contract embodying an investment which does not meet this definition? On the basis of such a definition of 'investment', can a host state invoke illegality under its own law to refuse to perform a contract, notwithstanding the general rule of international law referred to above?

On one view, the definition of investment in the BIT is only relevant where the investor seeks protection under the BIT. Where it simply makes a claim under the contract before a tribunal constituted under the contract, the BIT is entirely irrelevant. The BIT may grant protection to a limited class of investments but it does not operate beyond that class. Whilst it may protect only investments that are legal, it should have no effect on other investments ie those that are not legal. The BIT does not protect such illegal investments, but it does not prohibit them either. An investor making an illegal investment may not go before a BIT tribunal. However, it may seek the constitution of a tribunal under the contract and make its claims based on the contract. Where the contract is governed by international law, the body of rules of international law applicable to the contract will not include the BIT because the BIT expressly excludes the investment in question. However, the contract will still be governed by other principles of international law, including the general rule mentioned above — the host state may not invoke its internal law to refuse to perform a contract with a foreign investor.

However, on another view, the fact that both the host state and the home state of the investor have agreed to exclude illegal investments from the scope of the BIT means that such illegal investments should not be protected by international law. This is reinforced by the fact that a majority of BITs (70 per cent according to this research) exclude such illegal investments from their scope. This seems to represent a rule of customary international law that investments illegal under the law of the host state should not be protected by international law.

90 *Bilateral Investment Treaty between the Republic of Chile and the Republic of Austria*, signed 8 September 1997, ICSID Investment Treaties (entered into force 18 June 2000) art 11.

91 *Salini Costruttori SPA and Italstrade SPA v Kingdom of Morocco* (2003) 6 ICSID Rep 398, [46].

92 For criticism of such a decision, see Christian Borris and Rudolf Hennecke, 'Fraport v The Philippines — Compliance with National Laws: A Jurisdictional Requirement under BITs?' (2007) 5 *Transnational Dispute Management* <http://www.transnational-dispute-management.com/article.asp?key=1106>; Cf Christina Knahr, 'Investments "In Accordance with Host State Law"' (2007) 5 *Transnational Dispute Management* <http://www.transnational-dispute-management.com/article.asp?key=1070>.

It is submitted that this second view should not be accepted. The practice of states as evidenced in BITs is not yet sufficiently strong to establish a rule of customary international law that all investments illegal under the law of the host state should not be protected by international law. Many BITs do not define 'investments' as limited to those that comply with the law of the host state and hence still extend protection to investments illegal under such law. Even in the *Fraport* arbitration, the tribunal pointed out that the limitation to investments 'admitted in accordance with the law of the host state', only excludes from the BIT investments that are illegal at the time of admission. Investments that become illegal after their admission are not excluded from the BIT by way of this limitation[93] and therefore may still be entitled to BIT protection. Thus, there is still some unwillingness by states and international tribunals to deny protection to investments which are illegal under the law of the host state. As a result, this limitation in the definition of 'investment' in BITs does not have any impact on the contractual claims made by the investor where the contract is illegal under the law of the host state. Consequently, it does not have the effect of displacing the general rule of international law that a host state cannot invoke its internal law to refuse to perform contracts with foreign investors.

IV CONCLUSION

This article has examined the rules of international law on illegal contracts in order to demonstrate the applicability of general principles of law to state contracts governed by international law. The above discussions show that while general principles of law may form a useful source of international law for contractual issues, they may be difficult to ascertain, due to the likely differences in national legal systems. Where possible, it would be much more efficient to apply by analogy a rule of international law.

In relation to the substantive rules of international law on illegal contracts, this article points out that the sources of illegality of contracts under international law lie in rules of international law that impose mandatory obligations on the host state and, though less likely, the investor. Where a party must carry out, or has carried out, conduct under a state contract which contravenes such a mandatory rule of international law, there is a danger that the contract could be illegal under international law. Where the illegality is direct, serious and central to the contract, a general principle of law exists which considers the contract illegal. However, for other cases, where the illegality is less serious, no such general principle of law exists. A tribunal will need to apply a national law to determine whether the contract is illegal in that case. In fairness to the investor, I suggest that a tribunal should, where possible, apply a legal system which allows the tribunal to balance the interests of the investor and the public interests of the host state and the international community. It has also been shown that no rules of international

93 *Fraport AG Frankfurt Airport Services Worldwide v Republic of the Philippines (Award)* (ICSID Arbitral Tribunal, Case No ARB/03/25, 16 August 2007).

law exist regarding the consequences of the illegality for most state contracts with respect to the rights of innocent parties. In such cases, resort to a national system will again be necessary. All this highlights the uncertainty in this process, which makes it difficult to predict the outcome for a legal problem concerning the illegality of state contracts under international law.

As said at the beginning, this article only addresses some basic issues concerning illegality of state contracts under international law. Many other issues on this topic have not been explored and will gradually unfold through the practice of states and tribunals. For example, more sources of illegality will be identified and developed. Tribunals may start to develop international public policy, a breach of which, whilst not contravening any mandatory rules of international law, may also render a contract illegal.[94] The list of factors to take into account for determining whether a contract is illegal will be developed and refined over time. At some point in the future, sufficient rules will be developed to form an adequate body of international law on different aspects of the subject of illegal state contracts.

Finally, it should be pointed out that the discussions here are concerned only with the illegality and validity of contracts between investors and host states. It should be noted that even where a contract is found illegal and void under international law, the investor is not necessarily left without remedies against the host state. In the context of the state–alien relationship between the parties, the investor may still be able to raise claims against the host state for the latter's breaches of international law in respect to issues such as expropriation or fair and equitable treatment. The existence and extent of such international claims is not affected in any way by the discussions here.

94 Corruption is one example. See *World Duty Free Company Ltd v The Republic of Kenya (Jurisdiction)* (ICSID Arbitral Tribunal, Case No ARB/00/7, 4 October 2006).