The Role of the Domestic Law of the Host State in Determining the ratione materiae Jurisdiction of Investment Treaty Tribunals: The Partial Revival of the Localisation Theory

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Chapter 6: Partial Revival of the Localisation Theory in the Field of Investment Treaty Arbitration: The Current Role of Host State Law

Introduction

1. As it was shown in the previous Chapter, the 'localisation' theory rested on two pillars: first, the laws of the host state govern the substance of foreign investment dispute, and, second, only the courts of the host state are competent to decide cases filed pursuant to foreign investment contracts. Chapter 5 also recalled the destiny of the 'localisation' theory and reviewed what befell this theory, in particular, in the wake of the conclusion of a tremendous number of investment treaties containing arbitration clauses giving investors direct access to international arbitration against the receiving state. It was discussed in Chapter 5 that, as a result of the developments in international investment law, it was common ground in the 1990s that the 'localisation' theory had ceased to exist and did not have any practical effect.
2. Be that as it may, I demonstrated in Chapters 1-4 that the domestic law of the host state does have a significant role in determining a number of critical issues in an investment treaty arbitration, notably matters concerning the jurisdiction *ratione materiae* of an investment treaty tribunal. What I have not shown yet is the trend towards the inclination to the local law in investment treaty law in the course of time. I do not say that the laws of the host state had a determinative role in investment treaty cases from the very beginning of investment treaty case law. Rather, the argument is that this role was gradually attained by the municipal law through developments in treaty rulemaking and investment treaty arbitration jurisprudence.
3. Chapter 6 is entrusted with the task of distilling the in-depth discussions of Chapters 1 to 4 of this Thesis, followed by a brief consideration of the shift in the approach of investment treaty rulemaking and investment treaty arbitration practice towards the role of the laws of the host state in the field of investment treaty arbitration, thereby, outlining the overall impact of the laws of the host state on the outcome of investment treaty cases in light of the recent developments in investment treaty law. Thus, this Chapter will briefly show that the laws of the host state have obtained such a prominent role in investment treaty arbitrations in the course of time that one can consider the rematerialisation of the effects of the 'localisation' theory in the arena of investment treaty arbitration.

Section One: A Distillation of Chapters 1-3 Regarding the Role of the Domestic Law of the Host State in Determining the Jurisdiction *ratione materiae* of An Investment Treaty Tribunal

4. As was discussed in Chapter 1, there are several jurisdictional and substantive situations in an investment treaty arbitration in which the laws of the host state are determinative as 'law'. In particular, as delineated in Chapters 2 and 3, as far as the all-important issue of *ratione materiae* jurisdiction is concerned, the domestic laws of the host state have a significant role in several respects: (i) a majority of investment treaties provide that investments should be made in accordance with the laws of the host state.[1] The inclusion of the legality requirement in investment treaties got momentum gradually. In earlier BITs,

[1] See, for instance, Article 1(1) of the Agreement between the Government of the Kingdom of Sweden and the Government of the Republic of Kazakhstan on the Promotion and Reciprocal Protection of Investments, signed on 25 October 2004, entered into force on 01 August 2006.

the requirement that investments should be made in accordance with the laws of the host state was not expressly stated.[2] However, as time went by, more BITs began to include the legality requirement within their provisions.[3] Relying on these provisions, investment treaty tribunals have dismissed jurisdiction with regard to illegal investments. (ii) in most instances, the creation and existence of property rights underlying investment should be determined by reference to the laws of the host state.[4] [5]

5. This brief distillation of the discussions in Chapters 1-4 of this Thesis clearly manifests the reality that the local laws of the host state have regained some control in the arena of international investment law and have done so step by step. This progressive reassertion of the role of the internal laws of the receiving states is owed to two factors: first, in more recent years, states have started to leave more areas (jurisdictional or otherwise) in the hands of domestic law when they conclude investment treaties (investment treaty rulemaking), and, second, investment treaty tribunals have been granting a more prominent role to the laws of the host state in the resolution of investment treaty disputes (investment treaty arbitration practice). Coupled together, these two factors have given a firmer stance to the laws of the host state in the resolution of investment treaty disputes.

Section Two: Developments in Investment Treaty Law Regarding the Role of Host State Law in the Resolution of Investment Treaty Arbitration Cases

6. To begin with the new trends in investment treaty rulemaking, in order to really see the difference between previous practice and current practice, it is useful to make a comparison between states' older and newer model BITs. Although some states have not updated their model BITs, many have done so. The difference between the two model BITs manifests the difference in the approach to the role of host state law in a crystal-clear manner. To have a better picture, in the following paragraphs, I am going to raise the example of one

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[2] See, for instance, the Treaty between the Federal Republic of Germany and Pakistan for the Promotion and Protection of Investments, signed on 25 November 1959, entered into force on 28 April 1962; the Protocol between the Governments of the State of Kuwait and the Republic of Iraq on the Promotion of the Movement of Capital and Investments between the Two Countries, signed on 25 October 1964, entered into force on 07 June 1966; the Netherlands and Indonesia: Agreement on Economic Cooperation, signed on 07 July 1968, entered into force on 17 July 1971.

[3] See, for instance, Article 1(1) of the Agreement between the Republic of Austria and the State of Kuwait for the Encouragement and Reciprocal Protection of Investments, signed on 16 November 1996, entered into force on 22 September 1998; Article 1(1)(a) of the Agreement between Australia and the Islamic Republic of Pakistan on the Promotion and Protection of Investments, signed on 07 February 1998, entered into force on 14 October 1998; The Agreement between the Government of the Republic of Croatia and the Government of the Republic of Indonesia on the Promotion and Protection of Investments, signed on 10 September 2002, not yet entered into force.

[4] See Chapter 3, Section One.

[5] Furthermore, according to certain investment treaties, only investments will be protected which are approved by the competent authorities of the host state in accordance with their laws and regulations. See, for instance, Article 3(2) of the Agreement between Japan and the Islamic Republic of Iran on Reciprocal Promotion and Protection of Investment between Iran and Japan, signed on 05 February 2016, entered into force on 26 April 2017. Although the approval requirement did not usually show up in earlier investment treaties, in more recent years, one can see that this requirement is more frequently referred to by certain countries. See, for example, Article 2 of the Agreement between the Government of the Kingdom of Thailand and the Belgo-Luxemburg Economic Union on the Reciprocal Promotion and Protection of Investments, signed on 12 June 2002, entered into force on 19 September 2004; Article 10 of the Agreement on the Promotion and Reciprocal Protection of Investments between the Kingdom of Spain and the Islamic Republic of Iran, signed on 29 October 2002, entered into force on 13 July 2004.

developing country, namely India, and one developed country, namely, the Netherlands, and compare the contents of their older Model BITs with their latest Model BITs from the prism of the role of the municipal law of the host state in investment treaty law.

7. Beginning with the first example, i.e., India, the comparison is between the 2003 and 2015 Model BITs adopted by India. It should be borne in mind that the 2003 Indian Model BIT already had many references to host state law, e.g. with respect to the legality requirement. However, when one reads the 2015 version, one sees far more references to domestic law. Whereas the preamble of the 2003 Indian Model BIT makes no reference to domestic law, the preamble of the 2015 model reaffirms "the right of Parties to regulate investments in their territory in accordance with their law and policy objectives." Furthermore, it is notable that unlike the 2003 version, the 2015 Model BIT of India includes a comprehensive definition of the term 'law' in Article 1.6: ""law" includes: (i) the Constitution, legislation, subordinate/delegated legislation, laws & bylaws, rules & regulations, ordinance, notifications, policies, guidelines, procedures, administrative measures/executive actions at all levels of government, as amended, interpreted or modified from time to time; (ii) decisions, judgments, orders and decrees by Courts, regulatory authorities, judicial and administrative institutions having the force of law within the territory of a Party." There is also a definition of the term 'measure' in Article 1.8 which includes: "a law, regulation, rule, procedure, decision, administrative action, requirement or practice." Furthermore, Article 1.11 of the 2015 Model BIT also defines the term 'Pre-investment activity' and stipulates that such activity must be carried out in accordance with host state law.[6] Further expanding the trespassing role of the domestic laws of the host state, Article 2.4 of the 2015 Model BIT indicates that the Treaty does not apply to, *inter alia*: "any law or measure regarding taxation, including measures taken to enforce taxation obligations." Unlike, this broad limitation in the 2015 Model BIT, this limitation is confined to national treatment and most-favoured-nation treatment in the 2003 Model BIT (Article 3(3)(b)). In addition, the footnote to Article 5.1 of the 2015 Model BIT (enumerating the conditions for a lawful expropriation, including the condition of 'public purpose'), indicates that when India is the expropriating party, and the subject of expropriation is land, "any measure of expropriation relating to land shall be for the purposes as set out in its Law relating to land acquisition and any questions as to "public purpose" and compensation shall be determined in accordance with the procedure specified in such Law." Besides, Article 6(1) of the 2015 Model subjects the obligation to allow transfers of funds to the laws of the host state. On the same point, Article 6.3 enumerates various exceptions to the obligation of allowing the transfer of funds based on the legal and regulatory measures and policies of the host state. Another notable development in the 2015 Model is that although the draft treaty contains various express and implicit legality requirements, Article 11, entitled "Compliance with laws", records the agreement of the Contracting Parties that: "(i) Investors and their investments shall comply with all laws, regulations, administrative guidelines and policies of a Party concerning the establishment, acquisition, management, operation and disposition of investments … (iii) Investors and their investments shall comply with the

[6] "The term "Pre-investment activity" includes any activities undertaken by the investor or its enterprise prior to the establishment of the investment in accordance with the law of the Party where the investment is made. Any activity undertaken by the investor or its investment pursuant to compliance with sectoral limitations on foreign equity, and other limits and conditions applicable under any law relating to the admission of investments in the Party where the investment is made in specific sectors falls within the meaning of "Preinvestment activity"."

provisions of law of the Parties concerning taxation, including timely payment of their tax liabilities." A final notable insertion of domestic law in the latest version is the exclusion in Article 32.1(iii) of the adoption or enforcement by a Party of measures of general applicability applied on a nondiscriminatory basis that are necessary to ensure compliance with law and regulations that are not inconsistent with the provisions of the Agreement from the scope of the BIT. As one can see, when comparing the two Model BITs, the law of the host state has been given a much more expansive role in the more recent Model BIT, i.e., Indian Model BIT 2015.

8. Another noteworthy comparison could be made between the 2004 Netherlands Model BIT and the 2018 Netherlands Model BIT. Whereas the former Model did not contain an express legality requirement, Article 2(1) of the 2018 Model reads: "This Agreement shall apply to an investment, made in accordance with the applicable law of the host Contracting Party at the time the investment is made …" Along the same lines, and as another outstanding development, Article 7(1) of the 2018 Model BIT reads: "Investors and their investments shall comply with domestic laws and regulations of the host state, including laws and regulations on human rights, environmental protection and labor laws." Furthermore, as per Article 10(2) of the 2018 version, the recipient state has been given a margin of discretion to ensure compliance with its tax laws: "Nothing in this Agreement shall be construed to prevent a Party from adopting or maintaining any taxation measure aimed at preventing the avoidance or evasion of taxes pursuant to its tax laws or its agreements for the avoidance of double taxation." In addition, Article 11(3) of the 2018 Model BIT on the duty to allow the free transfer of funds, allows the host state to adopt certain measures for safeguarding its laws with respect to certain public purpose matters without taking such measures to be considered as violating the BIT. In short, as one can see, there are many more references to host state law in the newer model in contrast to the references to host state law in the previous Dutch Model BIT. When compared to the Indian Model BIT of 2015, although references to domestic law are understandably less in the 2018 Model BIT of the Netherlands, the fact that even the Netherlands, as a country which has never been a respondent in an investment treaty case so far, has felt the need to give host state law more relevance in its bilateral investment treaties is telling as to the overall approach of state practice regarding the role of host state law in the field of investment treaty law.
9. What these two case-studies simply show is that with the passing of time, states include more references to host state law in investment treaties with regard to both jurisdictional and liability matters. In fact, as these developments show, not only laws of the host state are more expressly mentioned to be determinative with respect to jurisdictional questions (like the legality requirement) but also state contracting parties to international investment agreements have shown a tendency to give some role to host state law in matters of liability by envisaging certain actions taken in accordance with host state laws as exceptions to treaty violations under certain peculiar circumstances.
10. Turning to the second factor, i.e., the shift in the investment treaty arbitration practice towards the role of host state law in investment treaty arbitrations, as was noted in Chapters 1 to 3, in recent years, many investment treaty arbitration tribunals have effectively and actually applied the laws of the host state to certain threshold jurisdictional matters like the creation and existence of rights or the legality requirement. This was not the practice in earlier investment treaty cases. In *Pope & Talbot Inc. v. Canada*, the tribunal had to decide

whether the alleged right of access to the US market was an investment protected by NAFTA and whether such an alleged investment was expropriated by Canada. Although the tribunal ultimately rejected the claimant's expropriation case on its merits, it had, as a preliminary point, accepted that the alleged right asserted by the claimant constituted an investment for the purposes of Article 1110 of NAFTA. Without engaging the domestic law of the host state, the tribunal found in general terms that: "true interests at stake are the Investment's asset base, the value of which is largely dependent on its export business".[7] As is plain from the foregoing quotation, the tribunal did not examine the alleged interest at issue from a legal prism and, as such, did not get itself into analysing the applicable municipal law of the host state. Rather, by alluding to the term 'true interests at stake', it approached the issue from a commercial perspective which does not seem to be the right way of dealing with this legal matter. This Interim Award dates back to 2000. Similarly, in a Partial Award rendered in 2005 in *Eureko v. Poland*, the majority of the investment treaty tribunal failed to appreciate the role of the host state law (laws of Poland) in determining the alleged contractual rights at stake and, instead, affirmed the existence of such alleged entitlements in an abstract manner divorced from any analysis of any internal law.[8]

11. In comparison, starting from 2003, beginning with the decision of the *Nagel* tribunal, investment treaty tribunals have gradually become more vocal regarding the role of domestic law of the host state in its 'law' cloak in the determination of the underlying legal rights and interests in investment treaty arbitrations.[9] In addition, other investment treaty tribunals have paid due regard to the laws of the host state in determining matters concerning the legality requirements and have made decisions and dismissed investment treaty cases based on those very laws.[10] That is while in the beginning, reference to host state law for dismissing an investment treaty case on the ground of illegality was done half-heartedly and without explicit reference to the specific laws of the host state.[11] Bearing in mind this shift in the jurisprudence, one can plainly consider the existence of an 'established trend' regarding the application of domestic law in the defined matters of *ratione materiae* jurisdiction.

Conclusion

12. As can be seen, although BITs came to wipe out all the traces of the 'localisation' theory, as time went by, states began to customise bilateral investment treaties in a way that would

[7] *Pope & Talbot Inc. v. The Government of Canada*, UNCITRAL, Interim Award, 26 June 2000 [98].

[8] *Eureko B.V. v. Republic of Poland*, UNCITRAL, Partial Award, 19 August 2005 [240]-[243].

[9] See, for instance, *William Nagel v. The Czech Republic*, SCC Case No. 049/2002, Final Award, 09 September 2003; *Generation Ukraine, Inc. v. Ukraine*, ICSID Case No. ARB/00/9, Award, 16 September 2003; *EnCana Corporation v. Republic of Ecuador*, LCIA Case No. UN3481, UNCITRAL *(formerly EnCana Corporation v. Government of the Republic of Ecuador)*, Award, 03 February 2006; *Emmis International Holding, B.V., Emmis Radio Operating, B.V., MEM Magyar Electronic Media Kereskedelmi és Szolgáltató Kft. v. The Republic of Hungary*, ICSID Case No. ARB/12/2, Award, 16 April 2014; *Accession Mezzanine Capital L.P. and Danubius Kereskedöház Vagyonkezelö Zrt. v. Hungary*, ICSID Case No. ARB/12/3, Award, 17 April 2015.

[10] See, for instance, *Fraport AG Frankfurt Airport Services Worldwide v. The Republic of the Philippines*, ICSID Case No. ARB/03/25, Award, 16 August 2007; *Alasdair Ross Anderson et al. v. Republic of Costa Rica*, ICSID Case No. ARB (AF)/07/3, Award, 19 May 2010; *Metal-Tech Ltd. v. Republic of Uzbekistan*, ICSID Case No. ARB/10/3, Award, 04 October 2013.

[11] See, e.g., *Inceysa Vallisoletana S.L. v. Republic of El Salvador*, ICSID Case No. ARB/03/26, Award, 02 August 2006.

revive the ‘localisation’ theory to a certain extent and with respect to certain outcome-determinative matters. As can be seen from the analysis conducted in this Chapter and in Part I of this Thesis, states, in particular, in more recent years, have hinged certain threshold jurisdictional matters to the determinations of host state law. In addition, state contracting parties to international investment agreements have shown a tendency to give some role to host state law in matters of liability by envisaging certain actions taken in accordance with host state laws as exceptions to treaty violations under certain peculiar circumstances. Furthermore, in the course of time, investment treaty tribunals also started appreciating the role of host state law in determining issues concerning subject-matter jurisdiction, thereby, reviving the function of these laws in the resolution of investment treaty cases to a certain extent.

13. However, as was alluded to above, this is only one side of the coin. The other pillar of the ‘localisation’ theory was that the court of the host state was the only competent forum for the settlement of investment disputes. This role was overtaken by the advent of bilateral investment treaties and was given away to international arbitration. It seems, however, that, like the laws of the host state, courts of the host state are also reoccupying some of their lost posts.