

HOW TO BITE THE APPLE

– ON LOCAL REMEDIES IN INVESTMENT TREATY ARBITRATION

By Joel Dahlquist¹

The principle that a mistreated foreign national has to attempt to seek a remedy in the host State before resorting to international measures has deep roots in international law. It is regarded as customary international law within the field of diplomatic protection, from which it has spread into other legal fields, one of them being arbitral proceedings under international investment agreements. This paper intends to explore the question of what the default situation is where such a treaty does not regulate the question of local remedies – does the established local remedies presumption from the field of diplomatic protection prevail?

This article answers the question partly in the negative. It is argued that there is no procedural requirement to attempt to seek local remedies before an arbitral tribunal's jurisdiction can be established. The requirement might however be included in the merits of an arbitral claim, as has been done by several recent arbitral tribunals. It is the view of this author that such an inclusion should be done with considerable caution. Outside of claims of denial of justice, and certain similar claims framed under comparable standards, local remedies should have a limited role in investment arbitration and the purpose and driving force behind the system must be stressed when applying them.

I. INTRODUCTION

Specific protection of foreign investments is a relatively novel legal area that has evolved quickly over the last couple of decades, and so have the different dispute resolution mechanisms associated with it. The common feature unique to these is that two States normally conclude an agreement that allows legal and private persons from those States to initiate international proceedings against the other State. Private entities can thereby base claims on a treaty signed by two States and use this against a sovereign, without having been party to the original agreement – so called “arbitration without privity”. Even though arbitration is the preferred way of solving disputes in the field, sometimes the claimant is obliged to first bring an action in the court sys-

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tem of the host State (the local remedies rule), depending on what has been agreed upon between the States. This uncertainty is sometimes referred to in terms of biting the allegorical apple or cherry. How many bites does a claimant get or, more relevant for this paper, where must he start eating?

The principle that procedural remedies in the host state need to be exhausted or attempted at before an international proceeding can be initiated derives from the law of diplomatic protection, giving any State discretionary rights to act against a second State that has injured a citizen of the first State, and to act on behalf of its citizens. It is commonly accepted that the local remedies rule is to be regarded as customary international law in such cases, evidenced in its inclusion in the International Law Commission's (ILC) two latest Drafts on Diplomatic Protection.² It is thus within this framework that the principle has been developed and is most established. Before the relatively new investment treaty scheme, the remedies available through diplomatic protection were a foreign investor's only option to pursue compensation from a host state. Treaty protection of investors' rights is however something different than diplomatic protection, because it is based on a State agreement and not on a softer principle of international law. This investment protection scheme has evolved in an exploding manner over the last decades and the more precise character of many of its elements remains unclear, simply because it has not been tested and argued enough. Whether or not the local remedies rule, "borrowed" from diplomatic protection, applies if nothing contrary is agreed upon is an open question that has not been sufficiently tested.

Bilateral Investment Treaties (BITs), the most common agreement on which to base investment arbitration, often refer to a specific investment dispute rule set or institution, the most established being the International Centre for Settlement of Investment Disputes (ICSID), as well as other rules such as those issued by the United Nations Commission on International Trade Law (UNCITRAL). The ICSID rules dismiss the local remedies rule by excluding it unless otherwise stated,³ while the UNCITRAL rules are silent, leaving it entirely up to the parties. The reason for UNCITRAL's silence is that these arbitration rules, though used frequently in investment arbitration, were drafted in a purely commercial context – meaning that the pursuit of local remedies would undermine the premise of the rules.

² Article 22 and 44 respectively. See also the *Interhandel* case, *Switzerland v. United States of America*, Issued by the International Court of Justice March 21 1959. ICJ Reports 1959, 27, Cited: *The Interhandel Case*, for the first time ICJ established the rule as customary international law.

³ ICSID Convention art 26.

If the local remedies rule *still* would apply in investment arbitration, as is the case with diplomatic protection, this might mean that it constitutes a procedural obstacle, in the sense that arbitration could not be initiated unless the claimant/investor has at least attempted to exhaust the local court system in the host state. It might also mean, as will be developed in this paper, that the rule is included in the material claim, thereby allowing a claimant to file before a tribunal, but effectively stopping the claim from succeeding unless attempts have been made at local rectification of the alleged mistreatment. There are at least eleven recent relevant investor-State cases where an arbitration tribunal has discussed the substantive or procedural function of the local remedies rule. In several of these cases, governed either by ICSID or UNCITRAL rules, the rule found its way into the tribunal's reasoning *even though the underlying treaties excluded it*. This was managed by applying the rule as part of the substance of the claim, as opposed to a procedural requirement. The development suggests that there is still room for the rule in modern investment arbitration and it might mean that it has a wider application than previously thought. The paper thus aims at answering the following question: when bilateral investment treaties do not explicitly include a provision providing for a requirement to attempt at local remedies before resorting to international arbitration, nor a release from the same requirement, should such an obligation be regarded as implicitly valid anyway?

2. THE SHIFT FROM DIPLOMATIC PROTECTION TO BIT PROTECTION

The trend has for some time been shifting away from diplomatic protection as a way of guarding foreign investments. States are exercising their sovereignty by submitting themselves, and investors from their jurisdiction, to international arbitration instead of diplomatic protection, thereby greatly reducing the relevance of the latter in the investment context.⁴ The exercise of diplomatic protection means that once an investor has exhausted the locally available remedies, the dispute is “transformed” into one in which the home State steps in and exercises its sovereign rights – the State thereby in theory replaces the investor as claimant.⁵ This exercise of the State's sovereignty is completely discretionary, meaning that it can choose not to intervene and not have to justify such a decision. From the perspective of the individual, this discretion on behalf of the home State is of course problematic. Once the home State decides to exercise its protective discretion, the resulting proceedings are on a State-State

4 Kokott, Juliane, *Interim Report on “The Exhaustion of Local Remedies”*, in: The International Law Association (ILA), Report of the Sixty-Ninth Conference, London, 2000, chapter A. 4, p. 25. Cited: Kokott 2000.

5 International Law Commission Preliminary Report on Diplomatic Protection 5, UN Doc. A/CN.4/484, 1998, para 16.

basis only, and the investor is at least theoretically not a party to the process. From a legal standpoint, it is the home State, and not its citizen, which has been injured. Before the BIT-practice and the establishment of ICSID, the lack of individual standing led some leading scholars to argue that the ICJ's jurisdiction should be extended to individual claims.⁶ That however never happened, but through the investment treaty practice, individual investors now have a forum to directly bring their claims.

Diplomatic protection as a means of securing investment rights is problematic for several reasons, besides the risk for political instability and lack of rule of law in the host State's judiciary system. As developed by the ICJ in the monumental *Barcelona Traction* case, diplomatic protection cannot be exercised to protect shareholders of a different nationality than the company.⁷ Accepting the underlying premise of diplomatic protection – the link between a State and its citizen – it is of course not strange that the same security cannot be granted to individuals who are not nationals of the protecting State. Some commentators even go so far as to say that investors, in the form of shareholders, are “unprotected by international law” if they have no State-level investment agreement to base their claim upon.⁸ This problem is even more present nowadays, given the multinational structure of most big corporations.

3. LOCAL REMEDIES IN BILATERAL INVESTMENT TREATIES

Under the ICSID Convention, the local remedies rule is explicitly waived unless the BIT-parties state otherwise.⁹ It is possible for a State to insist that the requirement should be included in the treaty; the ICSID includes several sample clauses for this purpose, as do most international instruments offering suggested draft language for investment treaties. It is thus up to the drafting States to choose how to structure their preferred way of dealing with the rule, leading to a plethora of different approaches.

Before the investment treaty development, the general understanding in international law seemed to be that the local remedies rule was *prima facie* applicable, even in cases where States submitted to arbitration and did not men-

6 Lauterpacht, Hersch, *The Subjects of the Law of Nations*, 63 *Law Quarterly Review*, 1947, p. 453 et seq.

7 *Barcelona Traction, Light and Power Company Ltd, Belgium v. Spain*, Issued by the International Court of Justice Feb 5 1970. ICJ Reports 1970, 3, para 44.

8 Masa'deh, Ahmad Khalaf, *International Rules for Investment and Investors: Light at the End of the Tunnel?*, 11 *European Business Law Review* (EBLR) 157 2000, p. 160.

9 Art 26.

tion the rule.¹⁰ When the ICSID Convention was introduced in the 1960s, its drafters made explicitly clear that the default exclusion of the rule was “not intended thereby to modify the rules of international law regarding the exhaustion of local remedies”.¹¹ At the same time, however, it was pointed out that in the context of investor-State arbitration, it could be presumed that “the intention of the parties is to have recourse to arbitration to the exclusion of any other remedy”.¹² From the outset, there was thus no intention to derogate from the previously accepted position of the local remedies rule, while at the same time the system’s very *raison d’être* was to offer an alternative. The ICSID rules have however come to be used as an efficient way of avoiding local remedies. The more recent development in the later part of the 20th century indicates that most treaties referring to ICSID arbitration do so without altering the presumption in art 26. This is part of a more general approach, keeping the BIT’s dispute provision as short as possible and leaving it to the institutional rules to fill the gaps with more detailed regulations.¹³ Arbitration pursuant to ICSID has therefore in effect established an exclusive forum, to a large degree sidestepping domestic litigation in foreign investment matters. The picture is however more complex: although virtually every BIT contains an arbitral clause, there is little to no uniformity in how these are structured. The few general tendencies one can extract is firstly that, at least in modern treaty drafting, ICSID is often referred to and secondly, it is common to leave the claimant some discretion to choose from other arbitral forms as well – most notably the UNCITRAL rules, but also the arbitral institutions at the Stockholm Chamber of Commerce (SCC) and the International Chamber of Commerce (ICC).¹⁴ The provisions adopt different approaches and may include conditioning dispute resolution through formal channels on attempts at amicable solutions¹⁵ or specifically including¹⁶ or excluding¹⁷ a local remedies requirement. Another common approach seems to be to provide for arbitration

10 Supra note 2, The Interhandel Case, p.27, Amerasinghe, Chittharanjan F, *Diplomatic Protection – Exhausting Local Remedies*, Oxford Scholarship Online, Published Jan 2009, p. 16.

11 Report of the Executive Directors on the Convention on the Settlement of Investment Disputes between States and Nationals of Other States, March 18, 1965, § 32.

12 Ibid.

13 United Nations Conference on Trade and Development, *Bilateral Investment Treaties 1995-2006: Trends in Investment Ruling*, 2007, p.100.

14 United Nations Conference on Trade and Development, *Investor-State Disputes Arising from Investment Treaties: a Review*, New York and Geneva, 2005, p. 5, Amerasinghe, Chittharanjan F, *Local Remedies in International Law*, 2nd ed., Cambridge University Press Cambridge, 2004, p. 268.

15 For example Sweden – Kazakhstan art 8(1), Netherlands – Ethiopia art 9(1), France – Uganda art 7.

16 See for instance China – Côte d’Ivoire art 9(3), Netherlands – Jamaica art 9, Austria – Armenia art 13(2). Romania has furthermore introduced the rule on a regular basis.

17 See for example Austria – UAE art 10(5).

if proceedings in local courts have not settled the dispute within a given time frame. This solution is seen in many oft-arbitrated Argentine BITs.¹⁸ Finally, it is common with clauses leaving the claimant/investor with the discretion to decide how and where to initiate the proceedings, often combined with a so-called “fork in the road”-clause. The essence of such a clause is to force the claimant to stick with the forum initially opted for, thereby precluding alternative channels.¹⁹ Typically, this means that an investor has to make a tactical choice to pursue either domestic litigation or international arbitration.

3.1 “SILENT” BITS

What is most interesting for the purpose of this text, however, is the fact that many treaties lack clauses that *regulate the question of local remedies at all*. This is most valid for BITs concluded before the late 1990s. Since arbitration caught on relatively late in treaty practice, there are a significant number of BITs that do not refer to this type of arbitration, and at the same time do not mention the local remedies rule at all. There might be several situations where the validity of an implied local remedies requirement is brought to the surface before a tribunal – for instance in discussing the limits or merits of vaguely drafted clauses containing such a requirement – but a completely silent BIT would by definition force a tribunal to discuss its implicit application. This category includes treaties such as those concluded between Bolivia – Sweden, Norway – Lithuania, and the now obsolete Netherlands – Czech and Slovak Republics. BITs that can be regarded as silent in this respect furthermore include those where other sets of arbitral rules are referred to: model rules such as UNCITRAL or institutional rules such as those of the ICC or SCC are primarily intended for commercial arbitration and as such do not require an attempt to seek local remedies. In a purely commercial context, that is a dispute between two private companies, a requirement to go to court would undermine the basic premise for choosing arbitration in the first place. Furthermore, these rules only apply after consent to arbitration has been established, logically making any reference to other remedies superfluous. It is thus important to remember that the question could arise also in claims based on a BIT where ICSID seems to be the preferred choice, since most such treaties present the claimant with alternative arbitral choices. If one expands the “silent” category to BITs with no explicit regulation of local remedies and the possibility to ar-

18 For elaborations on such clauses, see for example *ICS Inspection and Control Services v. Argentine*, PCA Case No. 2010-9, Issued Feb 10 2012, *Maffezini v. The Kingdom of Spain*, Decision on Jurisdiction, ICSID Case No. ARB/97/7, issued Jan 25, 2000, and *Abaclat and others v. The Argentine Republic*, ICSID Case No. ARN/07/5, Issued August 4th 2011.

19 See for example those concluded between France – Argentina art 8(2) and US – Czech Republic art VI(3).

bitrate under a non-ICSID regime, the potential for an unregulated situation grows tremendously. There is a great number of BITs wherein this could occur, including those referring to the important UNCITRAL complex.

It would be very illustrative to conduct a more comprehensive statistical survey of BITs and what type of dispute resolution-clause is used most often. No such empirical study has yet been performed, probably due to the efforts and time strains associated with the task. Ralph Alexander Lorz has however investigated a comprehensive sample of BITs, focusing on the 148 treaties concluded by Germany and their treatment of local remedies.²⁰ In short, he concludes that some tendencies can be detected in the treaty practice of Germany, a major BIT player. In the early BIT years, before the 1980s, the local remedies rule was either ignored or explicitly included. After that, the waiver started to appear, and in the most modern treaties the rule is nowhere to be found. Lorz believes this clear development suggests that Germany, over time, tried different solutions but settled for what it and its treaty partners considered the most suitable option: the waiver of the requirement.²¹ There is no reason to doubt this conclusion. Any random selection of BITs confirms that it is very unusual to see a modern BIT, concluded in the 21st century, which does not waive the rule entirely by referring to ICSID arbitration, or in plain language; save for the above-mentioned option of allowing the claimant to choose other rules.

3.2 SUBSTANCE OR PROCEDURE?

The local remedies rule, in its diplomatic protection-shape, has traditionally been labelled as a procedural one. It is however not self-evident that this is the case in investment arbitration. Some commentators argue that the rule is established enough to be included in the *substantive* part of a claim; a claim that has been discussed and abandoned in the diplomat protection-context. Treating the matter as a procedural one would mean that an arbitral claim would not be admissible unless at least an attempt has been made at local remedies. Treating it as a substantive one, on the other hand, would allow the tribunal to hear the case but might mean that the lack of attempts at local remedies could cause the claimant to lose the case on its merits, due to a lack of sufficient violation of the claimant's rights. The doctrinal debate on this matter seems to have outlived the change of application from diplomatic protection to investment arbitration; evident in both differing scholarly opinions and in arbitral tribunals reaching different conclusions on similar cases.

20 Lorz, Ralph Alexander, *Local Remedies Rule in Public International Law and in Investment Protection Law*, chapter in *General Public International Law and International Investment Law – A Research Sketch on Selected Issues*, ILA German Branch Working Group 2009.

21 Ibid p. 48.

3.2.1 ARBITRAL CASES

The local remedies rule, or hybrids of it, has been applied in several recent arbitral awards where the substance/procedure-distinction was brought to the surface. The following outlines a presentation of these cases, without the intention of being exhaustive. In order to provide an overview and stay as concise as possible, the very complex cases are summarized and only the factors relevant for this paper are extracted and discussed. Consequently, the following features are reviewed: the treaty upon which the arbitration was based, which arbitral rules were used, what the claimant argued (only the claims relevant for local remedies) and how the local remedies rule was or was not applied. The awards in which the tribunal elaborated on local remedies' substantial function are discussed somewhat more thoroughly.

Feldman 2002²²

Treaty: NAFTA

Arbitral rules: ICSID Additional Facility Rules

Material claim: Authorities failed to grant claimant tax rebates, claimed to be tantamount to expropriation and denial of justice.

Local remedies: Not applied as a substantive condition for expropriation but for denial of justice. The expropriation claim did however fail as well, and the failure to attempt to seek local remedies was one of several reasons for this and part of a bigger discussion.

Yaung Chi Oo Trading 2003²³

Treaty: ASEAN

Arbitral rules: ICSID

Material claim: Several expropriation acts, including armed seizure of factory.

Local remedies: The Tribunal declined jurisdiction but not on failure to exhaust local remedies, which it stated is a “matter going to the substance of the claim and not the Tribunal’s jurisdiction”.²⁴

22 Marvin Feldman v. Mexico, ICSID Case No. ARB(AF)/99/1, Award issued Dec 16, 2002. Cited: Feldman.

23 Yaung Chi Oo Trading PTE Ltd v. Myanmar, ASEAN I.D. Case No. ARB/01/1, Award issued March 31 2003. Cited: Yaung Chi Oo.

24 Yaung Chi Oo, para 40.

Loewen 2003²⁵

Treaty: NAFTA

Arbitral rules: ICSID

Material claim: Mistreatment in domestic court proceedings violating fair and equitable treatment.

Local remedies: Applied as going to the substance of the claim. Claimant could, at least in theory, have appealed the Court's decision to the Supreme Court and failure to do so made the claim fail on its merits.

The Loewen case is arguably the most controversial and has been discussed and criticized heavily since its issuing. It presented a very narrow view of when a denial of justice claim could succeed. The claimant had in this case been subjected to what the tribunal recognized was a disgracefully unfair and racist jury trial. He did not appeal to the US Supreme Court, because only a fraction of such appeals succeed and the requirement to post a bond during the waiting period would mean that the company would go bankrupt. Instead, the claimant settled the case prior to initiating arbitration. This failure to appeal through the national US system was held to frustrate the possibility of international responsibility under the investment treaty.

Generation Ukraine 2003²⁶

Treaty: Ukraine – US BIT

Arbitral rules: ICSID

Material claim: Investment was spoiled through administrative acts and omissions tantamount to expropriation.

Local remedies: Not applied as a procedural requirement but “expropriation is doubtful in the absence of a reasonable [...] effort by the investor to obtain correction”.²⁷

Generation Ukraine was arbitrated under the ICSID system, with a BIT not mentioning the local remedies rule, and the Tribunal reiterated that article 26 means the requirement was thereby waived.²⁸ The circumstances in the case did however

25 Loewen Group Inc. v. United States, ICSID Case No. ARB(AF)/98/3, Award on the merits issued June 26 2003, 7 ICSID Rep. 44. Cited: Loewen.

26 Generation Ukraine Inc. v. Ukraine, ICSID CASE No. ARB/00/9, Award Sept. 16 2003, 44 I.L.M 404. Cited: Generation Ukraine.

27 Generation Ukraine, para 20.30.

28 Ibid para 13.4.

lead the tribunal to discuss the rule. The background was that an American investor-claimant sought damages for the construction of a commercial property in Kyiv. The American corporation had established a local investment company and initiated the construction on site, but claimed that local authorities over six years time gradually obstructed the process to such a large degree that it was tantamount to indirect expropriation. The host State objected to the Tribunal's jurisdiction because, inter alia, "Ukrainian judicial remedies" had not been exhausted.

The Tribunal, while finding it had jurisdiction, expected from the claimant a "reasonable effort" to overcome the alleged mistreatment from the Ukrainian authorities. Without such a not necessarily exhaustive effort, the expropriation claim could not succeed on the merits and was thus denied.

Waste Management II 2004²⁹

Treaty: NAFTA

Arbitral rules: ICSID

Material claim: Expropriation due to mistreatment by City authorities and local courts, tantamount to violation of "fair and equitable treatment"- clause.

Local remedies: "Incorporated into the substantive standard and not only a procedural prerequisite".³⁰ City's mistreatment could not be expropriation as long as claimant could have sought redress; the Court's mistreatment had to meet the bar of denial of justice, which was not the case.

EnCana 2006³¹

Treaty: Canada – Ecuador BIT

Arbitral rules: UNCITRAL

Material claim: Local authorities failed to allow VAT refunds and claimed those previously granted should be refunded. Claimant argued this was tantamount to expropriation.

Local remedies: Applied as part of the merits and used to deny the claim. Dissent from Co-Arbitrator Naón arguing that the majority tried to re-introduce the rule when it was not in the BIT.

29 Waste Management Inc v. United Mexico States II, ICSID Case No. ARB(AF)/00/03, Final Award issued Apr. 30 2004, 43 I.L.M 967. Cited: Waste Management II.

30 Waste Management II, para 97.

31 EnCana Corporation v. Republic of Ecuador, LCIA Case No. UN348, issued Feb. 3 2006. Cited: EnCana.

The EnCana award, though not primarily about the local remedies rule, held that the claimant, a Canadian company, could not succeed with its expropriation claim since it had not tried to invoke all mechanisms available under the host State's law. The award is interesting in this aspect since co-arbitrator Grigera Naón argued in a partial dissent that levying a requirement to exhaust local remedies, when no such requirement was in the BIT, would suggest "the existence of a public international law hard-and-fast rule [on local remedies], binding on international arbitral tribunals", something which he opposed.³² The majority did not agree with this view and added in an extra note, after "careful consideration", that the award, in their view, concerned "whether the relevant rights have been expropriated as a matter of substance".³³ This holding clearly awarded the local remedies rule the dignity of a substantive standard.

Parkerings 2007³⁴

Treaty: Norway – Lithuania BIT

Arbitral rules: ICSID

Material claim: Expropriation and violation of fair and equitable treatment through City mistreatment and termination of contract.

Local remedies: Applied as substantive: no treaty violation (expropriation) since no complaint had been brought before appropriate local courts.

Helnan 2008³⁵

Treaty: Denmark – Egypt BIT

Arbitral rules: ICSID

Material claim: The State and the claimant's contractual counterpart conspired to force claimant to give up ownership of a luxury hotel, awaiting the State's ambition to privatize it. These actions amounted to expropriation and violated the "fair and equitable treatment" clause of the BIT.

Local remedies: Applied as substantive. The tribunal recognized that seeking local remedies was no procedural prerequisite to arbitration, but that Egypt could not be held internationally responsible under the BIT since the claimant had not attempted to rectify the respondent's conduct. In this incorporation

32 EnCana § 200, appended to the award.

33 Ibid note 138.

34 Parkerings-compagniet AS v. Republic of Lithuania, ICSID Case No. ARB/05/08. Issued Sep 11th, 2007. Cited: Parkerings.

35 Helnan International Hotels A/S v. Arab Republic of Egypt, ICSID Case No. ARB/05/19, Award issued July 3, 2008. Cited: Helnan.

of the requirement into the fair and equitable treatment standard, the tribunal relied on *Generation Ukraine*.

The *Helnan* award is relevant in this respect, since it was partially annulled by an ICSID ad-hoc committee.³⁶ The reason for this was that the committee regarded the tribunal's holding on the substantive local remedies requirement as an attempt to do "by the back door that which the Convention expressly excludes by the front door".³⁷ Reading such a requirement into the substance of a claim would deplete investment arbitration of its force and effect, the committee held.

The committee did however recognize that a failure to rectify misconducts in the local courts *could* be awarded a substantive relevance, as was made in *Generation Ukraine*. It distinguished the facts in *Helnan* from those in *Generation Ukraine* and argued that the different level of the mistreating State official affected the respondent's international responsibility. In the case of *Generation Ukraine*, the alleged mistreatment concerned a decision by a low level official, while in *Helnan* it was on a ministerial level. A respondent state, the committee reasoned, can be held directly responsible for the latter, but not for the former.

Saipem 2009³⁸

Treaty: Italy – Bangladesh BIT

Arbitral rules: ICSID

Material claim: State courts collaborated with claimant's contractual counterpart in order to set aside an ICC award in which claimant was awarded damages. Claimant argued that this was expropriation under the BIT.

Local remedies: Held not to apply to expropriation claims as a matter of principle (but to denial of justice). In this case, the investor had framed the claim as an expropriation and spent so much time litigating the matter that the success of further appeals was improbable. Local remedies were found to have been reasonably exhausted.

36 *Helnan International Hotels A/S v. Arab Republic of Egypt*, ICSID Case No. ARB/05/19, Annulment decision issued on June 14, 2010. Cited: *Helnan Annulment Decision*. Under the ICSID rules, awards cannot be appealed but annulled if a specially appointed committee finds procedural flaws.

37 *Helnan Annulment Decision*, para 47.

38 *Saipem S.p.A v. The Peoples' Republic of Bangladesh*, ICSID Case No. ARB/05/07, Award issued June 30, 2009. Cited: *Saipem*.

Pantechniki 2009³⁹

Treaty: Greece – Albania BIT

Arbitral rules: ICSID

Material claim: Riots damaged claimant's equipment, the respondent State settled the claim but never paid. When the claimant brought the failure to the local courts for assistance, it was denied. The claimant initially appealed to the Supreme Court but subsequently turned to ICSID arbitration instead. He claimed breach of "full protection and security", in the form of the failed protection of the physical property, as well as violation of "fair and equitable treatment" through the Court's mistreatment (denial of justice).

Local remedies: Applied on the second claim as part of the merits: the failure to fulfil the appeal process to the Albanian Supreme Court made a denial of justice claim impossible.

CHEVRON – TEXACO 2010⁴⁰

Treaty: US – Ecuador BIT

Arbitral rules: UNCITRAL

Material claim: National courts handled investors' contract breach-claim in a manner that violated the BIT-obligation to "provide effective means of asserting claims and enforcing rights with respect to investment, investment agreements, and investment authorizations".

Local remedies: Applied as a substantive "qualified requirement" of the clause. In this case, the claimants were found to have sufficiently attempted to seek local remedies and were awarded damages.

3.2.2 SCHOLARLY OPINIONS

Though the few commentaries on the "substantive development" of local remedies differ widely, most seem to agree on one point: in order to claim *denial of justice*, an investor has to at least reasonably attempt to seek, and probably exhaust, local remedies. The very allegation by definition contains a substantive element of local remedies and few scholars question this posi-

39 Pantechniki S.A. Contractors & Eng'rs v. The Republic of Albania, ICSID Case No. ARB/07/21, Award issued July 30, 2009. Cited: Pantechniki.

40 Chevron Corporation and Texaco Petroleum Corporation v. The Republic of Ecuador, UNCITRAL Arbitration, PCA Case No. 34877, Partial Awards on the Merits, Issued March 30, 2010. Cited: Chevron/Texaco.

tion as a general assertion. In order to establish an unlawful judicial act at the international level, an aberrant decision by a lower official does not generally suffice – the key reason for this is the fact that such conduct can still be corrected at a higher level, and no justice is denied before the system has been given that chance.⁴¹ The most detailed academic text published on the issue is written by George K. Foster.⁴² He argues that claims other than denial of justice may also include a substantive local remedies element, a view that is arguably shared by many of the presented arbitral cases. In short, three alternative assertions by claimants have been brought before tribunals and found to include local remedies, a result that Foster supports and explains:

1. **Violation of “fair and equitable treatment” clauses.** This standard BIT-clause is frequently used by investors in arbitral claims and its vague formulation has been given a wide interpretation by tribunals. The basic underlying argument for this, one which Foster agrees with and even analogically compares to the US Constitution’s fourteenth amendment, is that a State with an established judicial system in place to reverse erroneous decision, seldom can be said to treat investors unfairly or inequitably.⁴³ Foster’s US analogy to the fourteenth amendment – the “due process” clause – builds on the fact that the entire procedural system of a state has to be tested in order for a federal court to question its fairness.⁴⁴ US courts recognize exceptions to this, if attempts through local courts would be futile or ineffective – an approach similar to the one articulated in, for example, *Generation Ukraine*, making the analogy a good tool in explaining what constitutes fair and equitable treatment.
2. **Expropriation.** BITs generally do not prohibit expropriation per se; such acts can be justified by public purposes, as long as they are compensated as well as prompt and adequate. Foster has a US analogy ready for why local remedies should be regarded as inherent in these cases as well: the Supreme Court’s jurisprudence on the Fifth Amendment’s Takings Clause. Under this doctrine, uncompensated expropriation is not allowed but in order to establish such an expropriation, compensation has to be sought and

41 International Law Commission Second Report on State Responsibility, UN Doc. A/CN.4/498, 1999, para 75, Vandevelde, Kenneth J, *Bilateral Investment Treaties – History, Policy and Interpretation*, Oxford University Press Oxford, 2010, p. 484, Paulsson, Jan, *Denial of Justice in International Law*, Cambridge University Press Cambridge, 2005, p. 108.

42 Foster, George K, *Striking a Balance Between Investor Protections and National Sovereignty: The Relevance of Local Remedies in Investment Treaty Arbitration*, 49 Colum. J. Transnat’l L 204 2010-2011. Cited: Foster 2010.

43 Foster 2010, p. 245.

44 Ibid, p. 246.

denied.⁴⁵ This requirement reduces the need for federal intervention and protects state sovereignty.⁴⁶

- 3. Violation of “effective means of asserting claims” clauses.** This clause is similar to the fair and equitable treatment, and just as in the case of the latter, an arbitral tribunal will have a hard time assessing the effectiveness of the judicial system in the host State, if it has not been tested at all. This was most explicitly formulated by the Chevron-Texaco tribunal, which stated that “a failure to use these means may preclude recovery if it prevents a proper assessment of the ‘effectiveness’ of the system for asserting claims and enforcing rights”.⁴⁷

Foster thus finds four possible claims that may include substantive elements of local remedies: three more than the more established notion, which only attributes such a property to denial of justice, but arguably more in line with the presented arbitral awards.

Despite the widespread acceptance of local remedies as part of a successful denial of justice claim – and an arbitral development suggesting an even wider application – there are still notable academics who question the proposition that local remedies ever be included in the merits of an investment treaty dispute. The most articulated of these opponents are McLachlan, Shore and Weininger, who in their ambitious work⁴⁸ on investment arbitration criticize the development of including local remedies in the merits of claims. Commenting the Loewen award, the authors argue that “one must be very careful not to borrow principles from customary international law which are inconsistent with the hybrid nature of investment arbitration.”⁴⁹ The investment arbitration community is relatively small and a good illustration of this is that Campbell McLachlan, the co-author of the nominal work, sat on the ICSID committee that partly annulled the Helnan award because it regarded local remedies as a substantive part of the claim. The reasoning in that decision is more or less identical with the one in the book, stating that reading such a requirement back as part of the substantive cause of action would empty investment arbitration of force and effect and ignore the State parties’ intentions to avoid the pursuit of local remedies.⁵⁰

45 Ibid, p. 249 with references.

46 Ibid.

47 Chevron-Texaco, para 324.

48 McLachlan, Campbell, Shore, Laurence & Weininger, Matthew, *International Investment Arbitration, Substantive Principles*, Oxford University Press Oxford, 2007. Cited: McLachlan et al 2007.

49 McLachlan et al 2007, p. 232.

50 McLachlan et al 2007, p. 233.

Christoph Schreuer, who wrote the commentary on the ICSID Convention, has expressed concern that this theory of local remedies as a substantive standard risks undoing a fundamental aspect of modern investment arbitration. Like most commentators, he feels its inclusion is “hardly surprising” in cases of alleged denial of justice,⁵¹ but he is cautiously sceptical towards allowing it to be included in other claims. Writing before many of the awards presented in this article, Schreuer claims that the oldest and most discussed – *Loewen*, *Generation Ukraine* and *Waste Management II* – do not develop a general principle of attempts at domestic remedies requirement as a necessary element of a successful expropriation or fair and equitable treatment claim. Viewing the development of investment arbitration as an intentional way of getting around the restraints of diplomatic protection, he is however wary that the rationale behind the awards may develop into a re-introduction of the rule “by the back door”.⁵² Along these lines, Ursula Kriebaum writes in an essay collection in honour of Schreuer⁵³ that the impartiality and effectiveness of arbitral tribunals rely on the fact that they can act independently of domestic courts. Having a court determine whether an injustice has occurred and then expect a tribunal to respect the decision unless there has been a denial of justice – the approach feared by arbitrator Naón dissenting in *EnCana* but applied by the majority in that case as well as in *Waste Management and Parkerings* – would render investment arbitration a “less than subsidiary remedy.”⁵⁴ This, Kriebaum argues, would run completely against the purpose of treaty arbitration, which is to establish an exclusive alternative to domestic litigation.

4. THE FUTURE OF THE “SUBSTANTIVE REQUIREMENT” TREND

In traditional diplomatic protection, the local remedies rule is recognized as a procedural prerequisite to international adjudication, and if one views investment arbitration as an expression of diplomatic protection, the rule would simply follow. Consequently, this view – although it seems to be losing most of its weight over time – is found in more traditional spheres, emphasizing the rule’s roots in international law. Among these are Amerasinghe, who stresses that the ICJ and the international community have placed an

51 Schreuer, Christoph H, *Calvo’s Grandchildren: The Return of Local Remedies in Investment Arbitration*, *The Law and Practice of International Courts and Tribunals* 1, 2005, Martinus Nijhoff Publishers, Leiden. Cited: Schreuer 2005, p.14.

52 *Ibid.*, p.15 and p.17.

53 Kriebaum, Ursula, *Local Remedies and the Standards for the Protection of Foreign Investments*, chapter in *International Investment Law for the 21st century: Essays in Honour of Christoph Schreuer*, Oxford Scholarship Online, Sep 2009.

54 *Ibid.*, p. 46.

important presumption on local remedies and that this should prevail unless an express provision states otherwise.⁵⁵

This view is more or less derived from the ELSI case, delivered by the ICJ in a time before the development of BIT-based arbitration.⁵⁶ It is mostly found in older texts and seems to be heavily influenced by traditional diplomatic protection.⁵⁷ ELSI, and several other cases in which the procedural character of the rule was reiterated, preceded the arbitral awards presented in this paper. Even though that case is relatively modern, the signing of the FCN treaty occurred shortly after the Second World War, and States signing a contemporary BIT arguably have different expectations and notions of the importance of State sovereignty than did Italy and the US in the ELSI case.

As has been shown, investment arbitration filled a hole in international adjudication when it established a neutral forum for solving contentious FDI matters. Making access to this forum conditioned on first using domestic channels would completely run against the purpose of the entire structure. Furthermore, it makes no logical sense to rely on cases and principles from an older legal era in order to explain a superseding system, of which the primary motivation was to replace the older one. References to ICJ rulings on diplomatic protection, or to the ELSI case, should therefore be awarded very little significance in explaining prevailing principles of investment treaty arbitration.

For a progressive, arbitration-friendly jurist, the procedural prerequisite proposition would thus make no sense at all, and it seems that this opinion is spreading. None of the studied awards used the rule in this jurisdiction-blocking way, even though some of them definitely had the chance. This works to show that “investment law” is something other than traditional public international law and that an otherwise applicable procedural rule is implicitly waived, unless the disputing parties have agreed otherwise. The claim that the local remedies rule should work as a procedural rule is arguably outdated and actively disregarded by all major modern arbitral applications. The rest of the discussion will thus focus on a much more relevant aspect of the rule: its substantive character.

55 Amerasinghe, Chittharanjan F, *Diplomatic Protection – the Effect of Investment Treaties and of International Investment Law*, Oxford Scholarship Online, Published Jan 2009, p.1.

56 Elettronica Sicula S.p.A (ELSI), United States of America v. Italy, Issued by the International Court of Justice July 20 1989, ICJ Reports 1989, 15. Cited: ELSI.

57 See also Sornarajah, M, *Power and Justice in Foreign Investment Arbitration*, Kluwer Law International 1997 Volume 14 Issue 3, pp 103 – 140. p.135, Amerasinghe, Chittharanjan F, *Local Remedies in International Law*, 2nd ed., Cambridge University Press Cambridge, 2004, p. 249 et seq.

Since the local remedies rule is not regarded as procedural, while simultaneously abandoned in ICSID, NAFTA and most BITs, one might expect that an investor who wishes to arbitrate in this context could proceed straight to arbitration. The above cases have shown that this is not necessarily so. Depending on the nature of the alleged breach, local remedies might be considered a substantial requirement of the claim. It is far from clear when this is the case, and the applications and opinions on the issue differ. The notion of the rule's "substance element" is a highly contentious one, as demonstrated by the commentaries. The following will attempt to clarify its spheres of application and briefly discuss its ideal future.

4.1 DENIAL OF JUSTICE

In cases of denial of justice, the local remedies requirement ultimately derives from the duty imposed on the host State to provide a judicial system that allows for proper administration of justice – including the possibility to rectify wrongdoings. The international duty is not to treat every single matter dealing with foreign investors in a perfectly correct way; it is rather to provide a system which on the whole works to assure the rights of due process. Therefore, even though denial of justice sometimes is used as a rubber-like concept, flexibly reaching from procedural flaws in the individual case to systemic shortcomings of the entire judicial system of the host State,⁵⁸ not all cases should include attempts through domestic mechanisms. In order to successfully claim denial of justice, a systematic failure of the host State's judicial system must be shown. It is in the very nature of the concept that an error or misconduct cannot be rectified within the domestic system; otherwise justice has not been denied, and how can that be proven if the system is not tested? A requirement to at least attempt to seek, and probably also reasonably exhaust, local remedies should therefore be inherent in any notion of denial of justice. If not, decisions of lower courts or administrative bodies would be second-guessed by arbitral tribunals on a regular basis, making the latter an appellate body of sorts, which has never been the intention of investment arbitration. Its purpose, as has been emphasized in different contexts in this paper, was to establish a separate and exclusive forum – not to function as a "last instance" in relation to domestic courts.

An opposing view against allowing local remedies to play a substantial part in denial of justice claims, as argued by McLachlan et al, claims that the host State is responsible for all actions of its officials and thus not only for the entire system as such. In the international sense, they argue, the State has a single

58 Bjorklund, Andrea, *Reconciling State Sovereignty and Investor Protection in Denial of Justice Claims*, Virginia Journal of International Law, Vol. 45:4, 2005, p. 812.

legal personality. This leaves room to claim that a wrongful act by an official from the host State should produce international responsibility for the State, no matter the level or position of the official. An investor should therefore not have to go to court in order to get a BIT violation “confirmed” by superior bodies, since all agents of the host can invoke its international responsibility.

This argument seems to make the attribution synonymous with the responsibility of the host State. Those two notions should arguably be separated in any analysis examining whether international law has been breached.⁵⁹ An act that is attributable to the State, such as a peculiar decision by a low-level official, should not necessarily be something that the State should have to be held responsible for. The concepts are separated in the ILC draft on Internationally Wrongful Acts,⁶⁰ a division supported by Special Rapporteur Crawford.⁶¹ This division of the element of attribution and the element of an international breach is logical so far as local remedies are concerned: if such a remedy is available, a wrongful official decision attributable to the State does not invoke responsibility as long as the remedy has not been attempted at.

4.2 CLAIMS OTHER THAN DENIAL OF JUSTICE

If denial of justice should be a relatively clear-cut case of the substantial function of local remedies, other spheres of application are more contested. As shown by the arbitral awards, and summarized by Foster, there are three other material claims that have been found to include elements of the local remedies rule. A problematic aspect of this separation between denial of justice and other claims, as formulated most clearly in the *Saipem* award, is that it allows claimants – and ultimately tribunals – to introduce or avoid the local remedies requirement by labeling the claim as either denial of justice or something else, for example expropriation. The difference between these claims therefore needs to be crystallized.

The key feature that Foster stresses to justify including the rule in expropriation claims is the issue of compensation. Given that expropriation *per se* is seldom forbidden in BITs, he argues that a higher standard than mere seizure of property must be met. Essentially, an investor has to seek compensation and have it denied before an expropriation claim can be successful. This is a proposition with which I do not agree. Expropriation in the traditional sense, when the host State seizes assets from private entities because it is necessary on alleged public grounds, seems to be uncommon. A regular feature in the argu-

59 Foster 2010, p. 242.

60 International Law Commission Draft Articles on Responsibility of States for Internationally Wrongful Acts, UN Doc. A/56/10, 2001, compare chapter II and III.

61 International Law Commission Second Report on State Responsibility, UN Doc. A/CN.4/498, 1999, para 75.

ments in the presented arbitral awards is rather that a series of different public actions – tax decisions, contract terminations, obstructions – are alleged to be “tantamount to expropriation” or “indirect expropriation”. Formulating claims in this manner, it might not be entirely clear what an expropriation really is and how this differs from a denial of justice. There are however important differences, explaining the local remedies rule’s vital function in the latter case: for denial of justice, the entire treatment of the whole domestic system is relevant, while in expropriation cases the individual State organ’s action is enough to establish a breach. Consequently, whether or not a denial of justice has occurred cannot be judged unless the entire system has been given a chance, which should generally not be the case for expropriation claims. Furthermore, in the cases at hand, the alleged expropriation has been connected to contractual rights: the host acted as a commercial counterpart and not, as in denial of justice cases, as a State exercising its sovereign authority.

Given the emphasis put on avoiding local remedies in BIT practice, one should exercise extreme caution in reading it back. Granted, it is hard to avoid in denial of justice claims, but there is nothing to suggest that expropriation of contractual rights needs to be “confirmed” by a superior public body in the host State. Foster’s analogy to the US Constitution’s Taking Clause does not change this fact, since the relationship between a State and its citizens is fundamentally different from that between a State and a foreign citizen. Bilateral investment treaties exist simply because history has shown a need for an efficient and direct path to judicial protection for aliens and raising the bar for when this can be achieved in cases of expropriation would be very unfortunate.

The other examples of when local remedies have awarded substantial property are alleged breaches of “fair and equitable treatment” and, in *Chevron-Texaco*, the similar “effectiveness of the means provided” by the host in order to assert claims and enforce rights. In my view, there is more merit to the local remedies requirement in these contexts, at least under certain circumstances. Claims similar to denial of justice can be framed under these standards when the host’s misconduct does not reach the bar of denial of justice. On such occasions – where a decision, omission or order goes against the investor and there is easy access to a mean that could correct it – a host State is not very likely to have acted in a manner contrary to these standards. Using the above logic behind its inclusion in denial of justice, inserting some obligation to use of local judicial channels in order to allow an arbitral claim to succeed makes sense. If, and it is a big if, there is an accessible mechanism to rectify the alleged mistreatment, a claimant who has not attempted to use it should have a hard time meeting the

burden of proof that the host has not acted fairly and equitably or provided effective means.

5. CONCLUDING REMARKS

Arbitration, generally speaking, is intended as a way to circumvent courts and used as a tool for consenting parties to solve complex disputes with a binding force outside of traditional legal systems. In conventional arbitration, a rule that forces the suing party to first try local courts is of course an alien notion. In dispute resolution within public international law, however, such a rule is established as customary. Herein lays the inherent antagonism in investment arbitration: it allows two legal spheres to collide. The only set of arbitration rules aimed explicitly at investment arbitration, ICSID, has established the default position that attempts at local remedies should not be required. All other rules are naturally silent on the matter and there are BITs referring not to ICSID but to these other sets of rules, or, for that matter, to no rules at all but rather ad hoc-arbitration under domestic law. Is the presumption of exhaustion local remedies strong enough to prevail even in a party-driven arbitration context where it does not seem to be so familiar? It is my general view that it is not.

In the procedural sense, it is clear that no such obligation exists and nor should it. However, the rule seems to live on anyway. The local remedies requirement, in its substantive dress, has been invented by arbitral tribunals, which is manifestly problematic. Its inclusion in some claims – as well as how to distinguish when to include it – is technical, unpredictable and built upon legal principles that are very complicated to grasp, even for trained lawyers. Basically, it is everything that good law should not be. This is undesirable but can only be corrected by States in their treaty practice. Let States re-introduce the rule if they feel like it; a very improbable development, simply because few countries seem to feel it is desirable. Investment treaties are sophisticated tools formulated and agreed upon by sophisticated players. And what is more, the players are sovereign States! State sovereignty is often claimed to be the ultimate reason to uphold a strict demand for the local remedies rule, but in my view it is the respect for this very sovereignty that justifies abandoning the rule. One might have problems with the nature and structure of BITs, but the fact remains that they are a product of a State exercising its rights under international law, and this source should not be disregarded lightly. As a general rule, judges, and arbitrators even more so, ought to exercise caution in extending the reach of principles that have not been agreed upon by the parties to a treaty.

Despite these critical objections, allowing the local remedies requirement to be included as an element of certain material claims is, however criticized and

controversial, a reasonable notion. It should nevertheless be noted that these are to be viewed as exceptional, special cases deviating from the general rule that the local remedies requirement should be inserted with tremendous caution. For instance, the tendency to not allow expropriation claims to succeed unless several domestic institutions have confirmed it is undesirable and risks running afoul with the fundamental aspects of investment arbitration.

5.1 PRACTICAL IMPLICATIONS

Whether or not it might be worth at least pursuing domestic remedies is of course not as clear-cut as it might seem from this text. To be sure, any attempt at solving the dispute locally facilitates the eventual process in front of a tribunal. The higher up in the administration, or the more systematic, a host State's unfair behavior is, the more likely it is that an international tribunal will allow the claimant to succeed on the merits. The easiest way to achieve this is, naturally, to at least try to rectify the alleged initial wrong-doing within the frames of the domestic court system.

There are furthermore many sound policy reasons for stressing the use of local remedies. Firstly, it puts pressure on the host State to enable an efficient and fair legal system. The local remedies rule could work as a great incentive to establish a high judicial standard in order to attract lucrative foreign investment. In addition, initiating any procedure in the country of investment instead of internationally minimizes the risk for hostility associated with the latter. The investor might of course have an interest in keeping the dispute at a less provocative level, especially if intending to continue doing business in the host State, which is usually the case. These policy considerations, praiseworthy as they may be in the long run, are however of little consolation for the individual investor who has been mistreated in a foreign jurisdiction. In such cases, a tool for rectifying the wrongdoing is naturally what most individuals and enterprises look for, and in this respect, the local judiciary is more often than not an unsatisfactory option.

What is more, the fact that resorting to local remedies makes good policy sense is not a reason to introduce it with legal interpretational tools through an extensive reading of treaty clauses. This is especially true when the interpretation is done by ad hoc arbitrators. Good policy should be made by policy-makers, and privately appointed tribunals should not step into their place in their absence. As has been emphasized in this text, investor-State arbitration is a peculiar legal creature in the sense that private parties can arbitrate against foreign States without being party to the original arbitration agreement. This

is a delicate construction, one which should be treated with caution; especially given the critique against the powerful tools that are handed to corporations. Nevertheless, forcing investors to meet requirements that are not in the arbitration consent and that they cannot be reasonably expected to anticipate, threatens to de-stabilize the entire investment arbitration scheme.

When it comes to the role of local remedies in silent investment treaties, two countering interests are at stake and need to be balanced against each other. On one end is the investor's interest and those of an efficient arbitration system. On the other are opposing interests that are public in nature and stress the host State's rights. All authorities would probably agree that the local remedies requirement should be applied flexibly in the individual case, properly considering the interests involved and reaching a solution somewhere along this scale. As a general presumption however, it is my view that the investor's right, flowing from the State concluding the treaty, should be prioritized over the public end of the scale. States negotiating BITs are free to include the rule in one shape or another, but in the absence of such an inclusion, agreeing to arbitration should definitely raise a presumption that the obligation to attempt to seek local remedies has been waived. This presumption might be altered by the merits of certain cases, but should never the less be regarded as an important principle. To argue differently would not only mean relying too heavily on outdated principles of international law but also second-guessing the intention of the treaty parties – the States that actively sought an alternative mean of dispute resolution. It would also mean undermining the purpose of arbitration in a wider sense, because any agreement to arbitrate, in order to function properly, must necessarily prorogate litigation. Thus any application of local remedies in investment arbitration should be done with great caution and an understanding of the system's unique background. 