LAW APPLICABLE TO STATE ENTITIES IN INTERNATIONAL ARBITRATION

Tojiboyev Sarvar Zafarovich

https://doi.org/10.5281/zenodo.8278244

Abstract

This paper analyzes the law applicable to State entities in the scope of international commercial arbitration. The concept of incapacity, capacity to arbitrate and the notion of State immunity concerning State entities in international arbitration have been examined accordingly. The participation of State and State entities in international commercial arbitration is one of the most arguable and crucial issues in international legal practice. Controversial issues have been found in such cases where arbitral tribunals tried to expand the arbitral clause not only to State entities but also to the State in international commercial arbitrations. Arbitral tribunals have different views on the issues of legal personality of State entities. Some arbitral tribunals seek to expand the scope of arbitration clauses to cover the States, which are not formally signatories to the commercial contracts; meanwhile, national courts view that the separation of legal personalities between State and its organs or instrumentalities must be respected since they are different legal persons. Obviously, there is an increasing tension between two approaches in practice.

Key words: *law applicable, state entities, international commercial arbitration, concept of incapacity, capacity to arbitrate, state immunity, arbitrability, ex officio, authority doctrine, estoppel.*

Introduction

Generally, private parties are free to enter into agreements containing an arbitration clause. By contrast, State entities may not be able to take the same option by national constitutional or legislative provisions that constrain their authority to enter into binding arbitration agreements. Such burden of limitations on the capability of State entities to enter into arbitration agreements are mostly referred to by arbitral tribunals as "the State's capacity to enter into arbitration agreements"[1]. State entities usually propose a general principle that a sovereign State should not be a subject to any dispute resolution system not controlled by the State itself in order to make them escape their own prior commitment of submitting disputes to international arbitration. According to some scholars, "States' efforts to pre-emptively restrict the authority of their governmental agencies to enter into arbitration agreements are frequently motivated by lingering distrust of commercial arbitration generally, or a perception of international commercial arbitration as favoring private parties from industrialized countries.

The concept of incapacity of State entities

[1] Gary B. Born, "International commercial arbitration:[commentary and materials]," *The Hague: Kluwer Law International*, 2 (2009): 629.

At present, there is no universal definition in international legal practice regarding the concept of incapacity of State entities. However, many scholars note that incapacity of State entities refers to the inability of a natural or legal person to conclude and be a party to an arbitration agreement and incapacity to arbitrate.[2] In other words, the incapacity condition of State entities refers to the broader issue of a State entity's inability to act or exercise any rights on own behalf. Arbitral tribunals could consider the contract invalid if the parties to the contract lack the legal capacity when entering into it. In fact, national arbitration laws do not usually provide law governing the capacity to arbitrate while legal capacity to arbitrate usually fall on the identical foundation as the capacity to contract.[3] In principle, the general rule is that any natural or legal person with the legal capacity to enter into a valid and binding contract also has the legal capacity to conclude arbitration agreements.[4]

Capacity to arbitrate of State entities

Legal capacity is a general principle which is commonly found in private contract law, referring to the capacity of both natural and legal persons to become a party to and conclude an agreement, encompassing the ability to enjoy, to exercise the rights, and to perform the duties set forth by the contract. In the case that the parties lack the necessary capacity to enter into the contract from the beginning, the contract may be considered invalid. At the same time, most of the domestic laws on arbitration do not address the "capacity to arbitrate," legal capacity in the arbitration is therefore subject to the same basis as the general rule on capacity to contract.[5] In the case of private parties, the general rule means that a natural or a legal person possessing the capacity to enter into a valid agreement also possess the ability to conclude a valid arbitral agreement.[6]

With regard to the case of State entities, some entities try to restrict their own legal capacity by making reference to national laws or constitution limiting their power to conclude any valid arbitral agreement in order to avoid subjecting relevant disputes to arbitration pursuant to an otherwise-valid arbitration clause. Such national legal limitations fall clearly within the classic definitions of legal capacity, an understanding which was supported in the text of the applicable legal mechanisms.[7] For instance, the French version of the European Convention on International Commercial Arbitration, Article 2, mentions the capacity of legal persons under public law to be subject to arbitration while the English version uses the term "right" instead of "capacity".[8] Moreover, even when domestic laws allow the referral of disputes to arbitration, such referral may be conditional upon some legal authorizations: the issue can also be considered as implying agency rules concerning the power or authority of the parties to enter into an arbitral agreement.[9]

[2] Tai-heng Chang, and Ivo Entchev. "State incapacity and sovereign immunity in international arbitration." *SAcLJ* 26 (2014), 945
[3] Jean-François Poudret, and Sébastien Besson. *Comparative law of international arbitration* (Sweet & Maxwell, 2007), 270
[4] Steingruber, Andrea M. *Consent in international arbitration*, 3.06
[5] Poudret and Besson, *Comparative Law of International arbitration*, 270.
[6] Steingruber, *Consent in International Arbitration*, 3.06.
[7] Born, *International Commercial Arbitration*, 630–631; "No one can be bound by contract who does not have legal capacity to incur at least voidable contractual duties and the capacity to contract may be partial and its existence in respect of a particular transaction may depend upon the nature of the transaction or upon other circumstances".
[8] European Convention on International Commercial Arbitration, Article II(1).
[9] Fouchard Gaillard Goldman, *International Commercial Arbitration (Kluwer Law International*, 1999), 538.

Many national courts have made decisions about domestic restrictions on arbitration, mostly from the perspective of which disputes are arbitrable or able to be resolved through an arbitral process (more than the capacity of the parties themselves to enter into an arbitration agreement).[10] Some scholars have asserted that arbitrability must be considered both objectively and subjectively.[11] For a dispute to meet the arbitrability requirement not only the arbitral agreement must connect to a subject matter which is capable of resolution by way of arbitration (objective arbitrability), but the parties involved must have the capacity to submit the disputes to arbitral tribunals (subjective arbitrability). Since national legal provisions concerning the conditions on capacity to arbitrate limit the types of parties (such as State-owned and some types of public entities) who can refer the disputes to arbitral tribunals, rather than the categories of disputes that can be referred, they are deeply connected with subjective arbitrability.[12]

Some scholars have stated, in support of subjective arbitrability legal limitations on the ability of common private actors to conclude arbitral agreements usually seek to protect such private parties themselves. However, self-established limitations on States or State entities to conclude arbitral agreements, either directly or indirectly through its commercial agencies, are based on independent policy with reference to the State sovereignty principle or denial to consider arbitration as an institution.[13] Subjective arbitrability has also been affirmed by the French Court of Cassation, which has stated that legislative restriction provided by domestic French law is, in fact, not a question of capacity,[14] but is a matter of public interest unrelated to the legal limitations on the capacity of private parties.[15] Commentators supporting this "subjective arbitrability" further provide that restrictions imposed by the States, which imposing States can waive at any time, are decidedly different from flaws in the matter of legal capacity, which cannot usually be controlled by incapacitated parties.[16]

The alternative by these two optional characterizations of national limitations on the capacity of State entities to conclude arbitral agreements may designate the choice of law which will be applicable to resolve the matter. [17] This can have impacts on the efficiency of the restrictions.[18] Characterizing the matter as capacity may lead to situations where the courts or tribunals in civil law countries apply the domestic law of the respective state party; meanwhile, the courts in common law countries might decide to use the national law of the domicile of the party whose capacity is at issue.[19] Generally, the approach to choice-of-law might therefore affect a domestic legal limitation on States and State entities approving the submission of the dispute to arbitration (if the court does not try to avoid this outcome

[10] Steingruber, *Consent in International Arbitration*, 319; Goldman, *International Commercial Arbitration*, 534; Julian Lew et al, *Comparative International Commercial Arbitration* (Kluwer Law International, 2003), 27-6. Karl-Heinz Böckstiegel, "Public Policy and Arbitrability," *Comparative Arbitration Practice and Public Policy in Arbitration* (1987): 177-181.
[11] Goldman, *International Commercial Arbitration*, 311.
[12] Ibid.
[13] Steingruber, *Consent in International Arbitration*, 3.21.
[14] ONIC v Capitaine du SS San Carlo, Cass.1e civ, 14 April 1964, JCP, Ed G, Pt II, No 14,406 (1965).
[15] Steingruber, *Consent in International Arbitration*, 3.21.
[16] Ibid.
[17] Ibid.
[18] Ibid.
[19] Goldman, *International Commercial Arbitration*, 538.

through other corrective means, such as the apparent authority doctrine[20] or estoppel.[21] If the matter is not characterized as a problem of capacity, but rather related to the power or authority of signatories to conclude an arbitral agreement, the national law concerning the establishment or organization of such a State entity in question might be applied in both civil and common law countries under the identical corrective factors.[22]

In contrast, in case a court or tribunal in question considers the matter as an objective arbitrability, the public policy concerning which disputes can be submitted to arbitration, it could thus regard the request to force a State entity to arbitrate in the same manner as any other matter of international public policy. In other words, the courts, which review such an arbitral award, are able to evaluate the matter by applying the principles of international public policy affirmed in their national legal system.[23] For instance, in deciding that the French legal restriction on the arbitration of controversies concerning public bodies and public institutions did not apply to transnational commercial relationships. The tribunal referred to a rule of national substantive law that international public policy bans State entities from referring to their own domestic provisions for escaping from submitting their commercial disputes to arbitration.[24]

In the end, to characterize commonly believed limitations on the duties of sovereign entities under their arbitral agreements as concerning subjective arbitrability, not legal capacity, seems to be a way to deny finding incapacity of State entities. This approach is based on the practices of international arbitration and the legal texts of the many domestic laws and international agreements on arbitration, including the European Convention that expressly affirms "subjective arbitrability by default."[25] In addition, the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID Convention) relies upon the ground that a State that has concluded arbitral agreement must be bound by such agreement, which is closely related to the principle of *pacta sunt servanda*. However, even the cases where the courts define the issue as that of capacity, they usually apply some corrective elements, including restricting the extent of limitations to just national cases or relying on the estoppel principle to avoid it.[26]

The incapacity under the framework of the New York Convention

The New York Convention sets forth five grounds for refusal of foreign arbitral awards, plus two *ex officio*. Article V, paragraph (a), of the Convention states that "the parties to the agreement referred to in Article II were, under the law applicable to them, under some incapacity, or the said agreement is not valid under the law to which the parties have subjected it or, failing any indication thereon, under the law of the country where the award was made." Even though the New York Convention explicitly specifies the circumstances

[20] Apparent authority principle is a circumstance where a reasonable party to the contract would understand that an agent had power to act on behalf of principal; therefore, the principal is bound by the actions of agent, even though the agency does not have expressed or implied actual authority.
[21] Estoppel principle, which excludes a person from claiming anything in contradiction to what is implied by his or her previous action or statement or a previous judicial determination.
[22] Ibid.
[23] Ibid,
[24] Cour de Cassation, 2 May 1966, Trésor Public v Galakis, 93 Clunet 648 (1966); Cour d'Appel Paris, 10 April 1957, Myrtoon Steam Ship v Agent Judiciaire du Trésor, 85 Clunet 1002 (1958).
[25] The European Convention on International Commercial Arbitration, Article 2(1), provides that "legal persons considered by the law which is applicable to them as 'legal persons of public law' have the right to conclude valid arbitration agreements."
[26] Chang and Entchev, "State incapacity and sovereign immunity in international arbitration," 955.

where the agreement or contract stipulating arbitration is invalid or null, the primary ground for nullification or invalidation concerns the material or proper validity of the arbitration agreement and determines both capacity and appropriateness.[27] The subject matters under this provision include the incapacity condition that involves rational incompetence, physical inability, and absence of right to exercise on behalf of a legal entity.[28] The notion of incapacity condition in sense of Article V (1) (a) is deemed as the lack of right to conclude arbitration agreement.[29] Therefore, the problem occurs with respect to when the parties to the contract do not have capacity in accordance with the applicable law provided under the arbitration agreement. The New York Convention did not aim at establishing if the parties have essential capacity to conclude arbitration agreements, but rather left the regulation of the matter to the national legislation applicable to each party. Most of the problems derive from the law applicable to the contracting parties, "which is the law of place of domicile or incorporation, or the law of the place where the arbitration is taking place."[30] Generally, if a natural person that does not have essential legal capacity to conclude the arbitration agreement, such agreement is nullified. Therefore, legal capacity of legal entities, considering that some countries hold restrictions to arbitrate when the parties are governmental agencies or State entities, is to be discussed.

Many scholars believe that Article V (1) (a) of the New York Convention is a choice-of-law rule designating the personal law of the parties.[31] Nonetheless, in general, Article V (1) (a) cannot totally settle the issue of the law applicable to capacity matter, since it does not provide a complete definition of the personal law, which relies on choice-of-law rules of each State[32]. Hence, it depends on each State to choose which rules shall be applied to determine the capacity matter under the auspices of the New York Convention.

The concept of State immunity of State entities

The doctrine of state immunity was originally established under the UN Charter in (1945) and was confirmed by the Declaration on Principles of International Law concerning Friendly Relations and Co-operation among states in accordance with the Charter of the United Nations in 1970. The idea of "state immunity" was initially established as a general principle under international law, and afterward it was implemented into international treaties. States as a general principle of international law, referring to the ideology, nowadays accepts the state immunity principle that a sovereign state is not subjected to the authorities and influences of any other foreign State. Immunity of States is a guarantee to the equality of every State, and that one State will not exercise its sovereign power over another. This principle has been implemented in the domestic laws of the majority of countries.

[27] Jane Jenkins, Simon Stebbings, "International Construction Arbitration Law", *Kluwer Law International*, (2006), 442.
[28] International Council For Commercial Arbitration, ICCA'S GUIDE TO THE INTERPRETATION OF THE 1958 NEW YORK CONVENTION: A HANDBOOK FOR JUDGES, with the assistance of the Permanent Court of Arbitration Peace Palace, The Hague, 84, (accessed November 2017), http://www.arbitration-icca.org/media/1/13890217974630/judges_guide_english_composite_final_jan2014.pdf
[29] Ibid
[30] Ibid
[31] Gary B. Born, *International Commercial Arbitration* (Walter Kluwer, Law & Business, 2014) 3488; Herbert Kronke et. al., *"Recognition and Enforcement of Foreign Arbitral Awards: A Global Commentary on the New York Convention"*, (Wolter Kluwer Law & Business, 2010), 219.
[32] Ibid, 3489.

Significantly, immunity of the State refers to the independence of the State from the jurisdiction of foreign courts. In other words, the concept of state immunity is understood as the right of an independent State to be immune from the adjudication of foreign authorities. The concept includes all legal proceedings, ranging from the start of the process, service of judicial summons, investigation, interrogation by relevant officers, decisions, interim measures, and the execution or suspension, as well as subsequent release. In accordance with public international law, state immunity is considered a set of legal principles allowing a State to withdraw from the jurisdiction of foreign courts, to suspend the execution and not to accept derogations in favor of the jurisdiction of a foreign country. In addition, the primary objective of the concept of state immunity is to prevent the circumstances where domestic courts attempt to enforce their rulings over another sovereign State.

However, some scholars argue that sovereign immunity principle is not without a flaw because state immunity may largely reduce the efficiency of international commercial arbitration, influencing every stage of the arbitration proceedings provided that at least one party to arbitration is a State or State entity. In addition, the concept of state immunity derives originally from customary international law, which causes some difficulties for national judiciaries as there is no uniform and precise rule applying to all States and regulating all interpretations by each jurisdiction. Moreover, the principle might not only apply to the State itself, but also to its enterprises, agencies and other organs of the acting on behalf of such State.

Maniruzzaman points out that, as the government, its organs and the State-owned enterprises regard themselves as the representative of the State, any act of the government, its organs and the State-owned enterprises are therefore deemed to be conducted the State itself. State immunity is considered to be applied at two distinct levels, namely jurisdiction level and the execution or enforcement level. Further, the next section analyses state immunity in jurisdiction level.

Conclusion

In conclusion, state immunity does not exclude the State or State entities from withdrawing a dispute from the arbitral tribunals. As a primary principle of international law, state immunity is derogable by contract or arbitration agreement.[33] In fact, the New York Convention does not include concrete rules on the capacity of State and State entities. However, the provision under Article 1, paragraph 1, clearly determines that when the State or State entity is a party to an arbitration agreement, they are not excluded from the scope of the Convention.[34] In practice, when a State or State entity concludes an arbitration agreement with private party, it is deemed as the State or State entity has waived the immunity. This fact could make almost impossible for the State or State entity to enjoy its state immunity in the arbitral proceedings.

[33] Nigel Blackaby, Constantine Partasides, Alan Redfern, and Martin Hunter, *Redfern and Hunter on international arbitration* (Oxford Univ Pr, 2009) 667

[34] E. Gaillard, and D. Di Pietro, *Enforcement of Arbitration Agreements and International Arbitral Awards: The New York Convention 1958 in Practice* (2007) 841.

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