Private access to international adjudication has grown enormously over the last 30 years, no more so than with respect to investment.1 The spread of the adoption of investment treaties that entail private access, followed by increasing resort to the regimen by aggrieved investors, has provoked criticism and reappraisal. Critics in particular claim that regimes such as investment protection, which limit adjudication rights to foreign investors, unfairly gives the beneficiary class an extra layer of legal protection from government capriciousness and may contribute to the degradation of domestic institutions.

The extra-layer criticism comes in two forms. According to the standard account, an investment treaty provides foreign investors with special rights, and imposes special obligations on a host state. Typically, such a treaty will guarantee the investor fair and equitable treatment as to certain subjects, regulate the occasion for and the consequences of expropriation, and empower host states and investors to make and enforce certain kinds of contracts called stabilization agreements. A most-favoured-nation clause often will back up these commitments to ensure that the foreign investor covered by the treaty gets the most favourable rules applicable to any foreign investor. When a dispute arises

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and becomes subject to the arbitration process specified in the treaty, the arbiters look to the treaty for the substantive law that will determine what they do. Domestic entrepreneurs generally do not enjoy these rights, those who can structure their activities through treaty-eligible offshore holding companies excepted.

From this perspective, international investment law and the arbitral tribunals that apply it function autonomously. A treaty creates a distinct legal regime as well as distinct legal institutions. The tribunal decides only questions of international law. Municipal law comes back into the picture only when the prevailing party seeks to convert a monetary award into money through enforcement. Municipal law then identifies which assets are available for attachment and execution, as well as how these processes will work. Investment law thus acts as a substitute for municipal law, displacing both municipal substantive rules and legal institutions. Investors thus get a whole additional layer of substantive protection not available to persons who fail to qualify under the treaty.

The other form of the extra-layer criticism argues that treaty beneficiaries get access to an alternative legal system to review determinations of municipal law. According to this argument, host states do not enter into investment treaties primarily to upgrade the quality of their law. If foreign investors cared only about the content of the rules that constrain governmental action, changes in municipal law should suffice. What investors do not trust is not so much the governing law, but rather the institutions that will apply the law. Investors demand a more reliable dispute resolution process than the host state normally can provide. Thus, one can conceive of the investment law arbitration regime as an alternative venue for holding host states to the reasonable expectations created by their municipal law. What is unfair is allowing treaty-eligible investors access to superior rights protection, not the provision of superior rights as such.

This second perspective may seem to run against the standard account of modern international investment law. The investment treaties, so that account goes, displaces a body of customary international law that largely required host states only to treat foreign investors no worse than they did their own nationals. What the treaties did was replace national treatment, as this duty of nondiscrimination is known, with greater obligations. The treaties supplied new law, not merely new dispute resolution institutions.

Consider, though, one of the earliest modern attempts to reassure foreign investors and their sovereign. The 1783 Treaty of Paris that ended the Revolutionary War contained strong commitments by USA to honour the property and contract rights of British subjects. It did not specify a dispute settlement mechanism; that came later with the Jay Treaty, signed in 1794 and ratified in 1795. Rather than waiting for a new treaty to create the institutions that would reassure foreign investors, USA reformed its

municipal legal institutions. Its 1789 Constitution created the federal courts, a new body that would operate free of local prejudices that disfavoured foreigners. Through the exercise of their alienage jurisdiction, the new federal courts would provide foreigner business interests with a more effective means of vindicating rights that had their foundation on the common law of property and contract that the USA mostly shared with Great Britain.\(^5\)

A more recent illustration of the same concept can be found in the 1992 North American Free Trade Agreement (NAFTA). Chapter 19 of that treaty is taken directly from the earlier US–Canada Free Trade Agreement. Canada had sought to abolish antidumping and countervailing duties entirely, due to their largely protectionist function.\(^6\) When the USA balked, Canada made a new offer: the national law for antidumping and countervailing duties would still apply, but neutral arbitral bodies, rather than the specialized and, in the US case, remarkably protectionist courts, would review application of those duties. The USA agreed, and the arbitral bodies demonstrated a greater willingness to limit administrative discretion and protect foreigners than had the specialized national court. This combination of municipal law and international arbitral administrative review carried over into NAFTA.\(^7\)

On closer examination, however, this second form of investor protection need not function as a discriminatory regime in favour of foreign investors. Rather, one might regard the treaty system and municipal courts as competing for dispute resolution business. As long as local political interests dominate the courts, investors will take their disputes to the treaty bodies. But if municipal courts prefer influence to irrelevance, or if the local bar prefers taking the work that otherwise might go to the specialists who practice before international arbitral tribunals, then the municipal courts might try to raise their game to attract the business of aggrieved foreign investors. This competition might render international arbitration a complement to municipal litigation and consequently expand the rights of domestic entrepreneurs.\(^8\)

For a potentially virtuous competition between international arbitration and domestic litigation to unfold, both regimes must apply largely the same law. This means obviously that the legal constraints on governmental authority recognized and applied by municipal courts must at least match, if not exceed, the standards found in treaties and applied by arbitral tribunals. Less obviously, it also means that international tribunals must offer an alternative venue for hearing the most relevant claims under municipal public law.

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Among other things, the tribunals must operate as alternative public law bodies, applying municipal constitutional and administrative law.

In this article, I explore the implications of an arbitral review of municipal law. Section 1 discusses the issue conceptually. It argues that because the interests that treaties protect derive from municipal law, complete autonomy of international investment law is infeasible if not impossible. Section 2 illustrates the different stances that international tribunals might take through the lens of the Yukos dispute. In that prolonged and sprawling controversy, investment treaty tribunals have critically examined the substantive tax law pronouncements of the Russian national courts. The Strasbourg Court, in contrast, credulously accepted Russia’s claims about its substantive law, although it did condemn the procedures used by the government to enforce its tax claim. Section 3 considers the potential function of an international review of municipal law as a means for inducing national courts to lift themselves up and become effective promoters of the rule of law.

1. Treaty rights and municipal law

One can conceive of law as providing information about the future. From the perspective of a person who has a choice whether to engage with a particular legal system or not (i.e., an investor who controls mobile capital), the law provides a menu of consequences that will follow from the realization of particular outcomes. It will inform the observer, for example, that if business operations generate a profit of 100 units of the local currency, the government will levy a tax of, say, 15 units. The law cannot tell the observer what profits it will make, but it can predict how the government will measure profit and what percentage of that profit will go to the government as a tax.

All guesses about the future are risky, in the sense that events can upend expectations. The specific risk associated with a state’s laws—legal risk—lies in the possibility that expectations about the applicable law may go unrealized. The legal rule in question may be so indefinite as to defy precise prediction, the observer may fail to anticipate secondary rules that call off the primary rules that appear to apply to the transaction at hand, or the government may simply ignore its announced rules. Like all risks, legal risks constitute a cost of doing business that transactors will try to minimize.

Rich countries largely address this issue through their municipal law. They enact elaborate bodies of law to lend clarity to the expectations of persons engaged in commerce. They also create independent courts with the capacity to supervise the government. These courts, to varying degrees, hold the government to implicit as well as explicit promises that the nation’s laws make. Moreover, independent courts in most rich countries give some effect to the principle of legality, which denies the state the power to give retroactive effect to changes in its law.9

9 Eg Eastern Enterprises v Apfel, 524 U.S. 498 (1998). To be sure, the protection is somewhat constrained in administrative, as opposed to criminal, cases. The principle against retroactivity is subject to other countervailing principles in these instances. Eg Welch v Henry, 305 U.S. 675 (1938).
Elaborate rules and independent courts empowered to hold states accountable do not eliminate legal risk. Enacted laws leave room for interpretation. In addition, the principle of legality does not rule out prospective legal change. Of particular interest to investors, the principle leaves the legislature free to adopt new laws that affect future returns from existing investments. The prospective effect of such laws in turn can alter the present value of a prior investment. An investment offering an after-tax return of US$10 over 20 years would, using an internal rate of return of 10 per cent, be worth US$85.1. If, after the first year, the relevant state changes its tax laws to reduce the return to 5, the investment would nearly halve in value. Lots of law and strong legal institutions, in other words, cannot protect against the effects of legislative capacity to change the law.

Even this last problem can be solved, however, if the state can contract for certain kinds of stability with a private party and if the state’s courts will enforce the contract. Such arrangements are unusual but not unheard of in the rich world. The efficacy of the mechanism as a means of reducing legal risk, however, depends mostly on the capacity of the institution responsible for enforcing the contract.

Investment treaties emerged as a device by which countries that lacked legal institutions with a proven record of effectiveness could reduce foreign investors’ legal risk. Although the treaty obligations were reciprocal, the need for the treaty obligations was not symmetrical. Most rich countries offered foreign investors at least as much protection in their municipal courts as the investment treaty provided through investor-host state arbitration. Developing and emerging-markets countries, by contrast, often had weak and dependent judicial systems, a history of legislative capriciousness subject to political expediency, or, in the case of formerly autocratic and autarkic countries, simply no track record by which one could assess legal risk.

Superficially, investment treaties address the issue by specifying legal duties that host states have with regard to foreign investors. Each of these duties emanates from treaty language, and thus rests on international law. But all of them refer to the content of municipal law. Each invites a reviewing body, typically an arbitral tribunal operating under terms of reference determined by the investment treaty, to compare the host state’s behaviour to the legitimate expectations that its municipal law created. The enforcement of the international legal duty thus requires a review of municipal law.

Consider a concession granted by a state to a foreign investor to explore for, develop and exploit a potential oil and gas field. After discovery, the construction of rigs, storage and transport facilities, and the commencement of commercial operations, the state


12 To be sure, the narrative is a bit more complex. Perhaps to the surprise of some, foreign investors in a few instances have brought treaty claims against rich states before arbitral tribunals, apparently seeing a greater potential payoff in this process compared to the municipal law protection available. Eg Loewen Group, Inc. v United States, Case No. ARB/(AF)/98/3, Award on the Merits, 26 June 2003; Mondev International Ltd. v United States, Case No. ARB/(AF)/99/2, Award on the Merits, 11 October 2002. For further discussion of these cases and the interactions between international and municipal law, see PB Stephan, 'Redistributive Litigation—Judicial Innovation, Private Expectations and the Shadow of International Law' (2002) 88 VLR 789, 811–13. To the extent such cases become frequent rather than episodic, the argument in the text is weakened.
revokes the concession and takes over operation of the field. Is this an expropriation? One cannot answer the question without considering the terms of the concession. Did the concession by its terms terminate at the will of either of the parties? Did some part of the state’s public law make clear that violation of certain duties would result in a forfeit of the concession? Did the investor violate such duties? All these are questions of municipal, not international, law.

Similarly, to determine whether a host sovereign behaved in an arbitrary or discriminatory fashion, one must know how it normally behaves. If its conduct, however injurious, corresponds to its well-established past practice, applicable to nationals as much as to foreigners, the case for finding a violation of the requirement for fair and equitable treatment diminishes. And, as for special contracts enforceable under an investment treaty’s umbrella clause, contract interpretation resting in municipal law plays a central role in determining the relevant rights and duties.

This argument does not mean that enforcement of an investment treaty necessarily involves a searching inquiry into the content and meaning of municipal law. An arbitral tribunal might instead rely on any of a range of presumptions. It might, for example, regard the pronouncements of municipal courts as authoritative, however suspect the integrity and independence of those bodies might be. In addition, it might give great deference to the host state’s government as to the characterization and interpretation of its law. Alternatively, it might assume that a host state’s general legal practice conforms to that normally expected of rich countries. The point simply is that the arbitral tribunal must come to some conclusion about municipal law, even if it does not base its determination on a close analysis of evidence about actual practice.

Of course, investment arbitration can never be a perfect substitute for domestic litigation. Arbitration by its nature limits the authority of the tribunal through its terms of reference. Municipal courts need not face analogous constraints. Different systems may have different traditions about the limits of judicial power, which may turn on matters other than an express constitutional or legislative delegation of authority to the judiciary. The point is only that international tribunals and municipal courts might overlap in function sufficiently to make the process of applying municipal laws functionally equivalent.

Choices about how to go about finding municipal law have significant consequences for the investment treaty regime. An inclination to accept as conclusive the pronouncements of local authorities, whether courts or governments, in most cases will make it hard to find a treaty violation. An assumption that local practice conforms to rich world standards might have the opposite effect. A searching inquiry into local legal practice may give the tribunal greater discretion, if the parties’ local-law experts produce the usual contradictory accounts. The general point is that investment treaty enforcement requires some reference to municipal law, and that the manner of making that reference will have substantive consequences.
2. An illustration: the Yukos dispute

The conflict between the Russian government and Yukos, once that country’s largest oil producer, brings together international investment law, municipal law, and high and low politics. Controversy dogged the company from its privatization in 1996. After a period of consolidation and restructuring that provoked litigation and sharp criticism, Yukos at the dawn of the new millennium sought to reposition itself as a model of transparency and good corporate governance among Russian firms. A series of mergers, buoyed by the rising world price of crude oil, greatly increased the firm’s value. A proposed alliance with a western partner put the company on the brink of becoming not only Russia’s, but the world’s largest oil company.

At the pinnacle of the company’s success in 2003, Mikhail Khodorkovsky, its principal shareholder, publicly criticized Russia’s President Putin and intimated possible political ambitions for himself. A few months later, Khodorkovsky and other Yukos executives were in jail facing charges of tax fraud. The government brought tax charges against the company in 2004, froze its assets, and then sold off its production companies, the principal source of the company’s revenues, to offset the tax debt. Rosneft, the principal state-owned oil company, acquired almost all of Yukos’s domestic assets, including its production companies. A bankruptcy court liquidated the company in 2007. Because the tax levy exceeded the amount realized in bankruptcy, shareholders got nothing.

The heart of the Russian government’s case against the company entailed the attribution to Yukos of transactions undertaken by trading entities set up in domestic tax havens. During the 1990s, the Yeltsin administration had used tax privileges to encourage the economic revival of regions that either had suffered from the collapse of the Soviet military–industrial complex or contained restive non-Russian minorities. The energy industry had seized on this loophole by setting up intermediary companies in these regions. Production companies controlled by a holding company would sell product to a trading company at knock-down prices, which in turn would sell to foreign purchasers at world market prices. If the tax authorities were to respect the form of these transactions, the production companies would not book a profit and thus avoid the Russian profits (corporate income) tax and the trading company would enjoy a profits tax exemption. The production company would collect a value-added tax (VAT) from the trading companies at the time of sale, but export sales would qualify the trading companies for a full VAT refund (the normal rule for VATs, not in any way a tax privilege). Throughout the 1990s, the industry essentially avoided profits taxation through this structure.

Yukos followed industry practice. It did not own the trading companies with which it dealt, although some suspected that the nominal owners of those companies were

13 At various times, I have provided legal advice and expert testimony to Yukos, Yukos shareholders, and offshore Yukos subsidiaries in connection with this dispute. My involvement in the case is ongoing. The reader should be aware that what I say in this article reflects positions I have taken in these matters.

14 For a more detailed account, see PB Stephan, ‘Taxation and Expropriation—The Destruction of the Yukos Oil Empire’ (2013) 35 HOU JIL 1, 5–27.
placeholders acting under the control of Yukos management. Departing from industry practice, it sought to regularize these entities by using them on a regular business, rather than liquidating each entity after a single transaction. Yukos then contracted with the trading companies to provide a wide range of services, including banking, accounting, and acting as a consignment agent to find buyers for the product and to arrange for shipping.

Recognizing the gross inefficiencies built into the domestic-tax-haven regime, the Russian legislature abolished the privilege as of 2001. Yukos, like other energy companies, reduced its reliance on this structure. When the case against the company began in 2004, however, the tax authorities focused on the trading companies, even though they would have no legal significance in future years.

The Russian Tax Code provided the government with several tools for challenging these transactions. It contained transfer pricing rules that would have allowed the authorities to reprice the sales made by the production companies so as to attribute profit to them.\(^\text{15}\) The authorities might have gone after the trading companies, challenging their eligibility to the tax privileges that they claimed. To the extent that the trading companies passed on their profits to Yukos, the authorities could have levied an income tax on these downstream transactions.

Each of these strategies presented problems, however. At a technical level, legal and evidentiary issues might have limited the amount of recoverable taxes. More fundamentally, however, the government at most would have recovered unpaid profits tax, and even total victory on that issue would not have generated an amount sufficient to bankrupt Yukos.

The authorities instead invoked an unprecedented legal theory. It argued that Yukos exercised comprehensive control over the crude oil purchased and sold by the trading companies. This control, it argued, made Yukos the ‘actual owner’ of the oil. As owner, not only was it liable for the profits tax, but it also bore responsibility for all VAT due on the sale of the crude oil to ultimate purchasers. Although the Tax Code applied a ‘zero rate’ to export sales, the exporter bore the burden of submitting specified documents establishing the terms of the export transactions. This Yukos had failed to do, thus rendering it liable for VAT at the rate applicable to domestic sales.

The authorities backed up this substantive theory with several procedural moves, some innovative. First, it requested and received a judicial order freezing Yukos’s assets. This did not interfere with normal business operations, but it did prevent Yukos from liquidating assets, in particular marketable securities obtained in a recent merger with Sibneft, another Russian oil major, to pay off the tax claim. Secondly, it persuaded the courts that the 3-year statute of limitations applicable to fines and penalties did not apply to Yukos, on the grounds that Yukos had tried to conceal its relationship with the trading companies. This claim opened up the 2000 tax year, the last year in which the trading company mechanism produced significant profits tax savings, and thus substantially...

\(^{15}\) Russian Tax Code art 40.
increased Yukos’s exposure to fines and penalties. Thirdly, although the initial assessment
covered only the 2000 tax year, the authorities levied new assessments, limited mostly to
unpaid VAT, for 2001–2003. In these new assessments, the authorities argued that Yukos
should face additional fines and penalties as a recidivist, even though the statute
providing for this sanction seemed to apply only to taxpayers who continued to claim tax
savings after a court had adjudged its accounting improper.

Over the course of the spring and summer of 2004, the Russian courts upheld the
initial assessment for the 2000 tax year. Those Yukos executives who were not in prison
or outside the country offered to settle the claim, but the authorities refused to allow
them to sell Sibneft stock or other assets that would produce sufficient cash. Instead, the
authorities added assessments for 2001 through 2003, all resting on the same legal theory
but mostly comprising unpaid VAT. In late 2004, the tax authorities auctioned off
Yuganskneftegaz (YNG), the most valuable of Yukos’s three production companies, to a
dummy company. The next day, the dummy sold YNG to Rosneft, the state-owned oil
company. The authorities then put Yukos into bankruptcy, and in 2007 obtained a court
order for its liquidation. Rosneft ended up with almost all of the remaining Yukos assets.

This seeming local dispute between the Russian government and a Russian oligarch
implicated two bodies of international law. First, many shareholders were foreign
nationals and thus had the capacity to claim rights under investment treaties or, in the
case of US nationals and others whose states did not have a treaty, customary
international law. Second, Yukos itself (as well as its top leadership) claimed that Russia
had violated the European Convention on Human Rights and sought redress in the
Strasbourg Court. These rights extended to Russian nationals, not just (or even
primarily) to foreigners.

To date, three arbitral tribunals and the Strasbourg Court have been seized with the
dispute. The first case, involving Russia’s treaty with the UK, resulted in a modest victory
for shareholders who had purchased Yukos stock after the tax dispute had arisen.16 The
Strasbourg Court then gave Yukos a mixed result, ruling that the tax assessment was
legitimate but that the enforcement process violated European human rights law.17 A
tribunal constituted under Russia’s treaty with Spain then ruled in the investors’ favour,
in passing criticizing the reasoning of the Strasbourg Court regarding the tax
assessment.18 Finally, a tribunal established under the Energy Charter Treaty also
rejected Russia’s tax theory and ruled that the government had expropriated the company
in violation of its treaty obligations.19

For our purposes, the contrasting approaches of the investment tribunals and the
Strasbourg Court to the substantive tax claim are instructive. The Strasbourg court made

19 Hulley Enterprises Ltd. (Cyprus) v Russian Fed’n, 2014 I.L.C. __ (Per. Ct. Arb. 2014); Yukos Universal Ltd. (Isle of Man) v
documents, are virtually identical.
no serious effort to look behind the Russian government’s description of its tax law. The three investment tribunals, by contrast, closely examined evidence as to general Russian tax practice and found the Russian account of its legal norms implausible.

As a matter of Russian tax law, the fundamental question was the existence of a legal mechanism that would attribute the trading companies’ transactions to Yukos. As the time of the 2004 assessment and subsequent Russian litigation, the tax authorities made a simple, but bizarre, argument. They observed that Article 209 of Russia’s Civil Code provides that an owner of property has the right to possess, use and dispose of that property.20 This formulation matches what one would find in most civil codes around the world. What the authorities argued, however, and the Russian courts accepted, was that one who had the capacity to exercise these rights was for that reason the owner of property. Because various contracts between Yukos and the companies gave it these powers, Yukos qualified as the owner of the crude oil purchased from YNG and sold to foreign customers.

There are many reasons why this was a silly argument. Article 209 does not purport to define who is an owner, but rather describes the legal consequences of being an owner. The point is critical, because under Russian law, as is true in almost every private law regime around the world, persons who are not owners also can exercise these powers. Russian law, for example, allows for agency, delegation and similar mechanisms that provide non-owners with the ability to possess, use and dispose of property.21

Apparently mindful of the inadequacy of the theory that had sufficed in its own courts, the Russian government constructed another and more sophisticated account of its law when it appeared before international tribunals. It argued that Russian courts, including the Constitutional Court, had recognized a distinction between good-faith and bad-faith taxpayers. The former were entitled to rely on their evident legal status, however formalistic it might be. But persons who chose legal forms in bad faith to exploit gaps in the tax system could not do the same. As a result, Russia’s lawyers argued, the trading companies might have been the ‘actual owner’ of the crude oil that passed through their hands under the civil law, but for tax purposes, and as a matter of judicially promulgated tax doctrine, Yukos was the owner.

This argument could not be dismissed so easily. Many jurisdictions around the world recognize that sophisticated tax planners engage in an arms race with tax collectors. Planners choose transactional forms that minimize tax liabilities while allowing the taxpayer to achieve its commercial objectives. Tax collectors seek to recharacterize the transaction by invoking some sort of ‘substance over form’ doctrine.22 Moreover, most private law systems incorporate an implicit or explicit principle of good faith that bars

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20 Russian Civil Code art 209.
21 ibid arts 971–1004.
transactors from engaging in transactions to deceive or harm others. The Russian argument in the international tribunals essentially tried to spin these concepts together: transactions undertaken only to avoid taxes deceived or harmed the national fisc, and thus constituted bad faith. When faced with such a transaction, the tax authorities could disregard it and impose tax liability on the basis of a proper reconstruction of what the taxpayer intended to achieve commercially.

Yukos, of course, did not accept the government’s argument. It noted that the Russian Tax Code referred to the Civil Code as the basis for transactional characterizations, absent an express overriding rule in the Tax Code. The Civil Code in turn provided for recharacterization of transactions founded on deceit or illegality. But Yukos had fully disclosed its relationship with the trading companies. There was nothing in the Civil Code indicating that the pursuit of lower taxes constituted bad faith.

Especially problematic for the Russian government was its levy of VAT taxes on Yukos. Russian law, like that of every VAT system in the world, imposed a zero rate on exports. This feature ensures that the VAT falls on only domestic consumption of goods and services. When exporting, the trading companies had filed all the documents required under the Tax Code to establish eligibility for the zero rate. The Russian government’s ‘actual owner’ theory conceded that Yukos had exported crude oil. But, the government argued, the documents filed by the trading companies were inadequate, because Yukos had not submitted them on its own behalf. Without a proper submission, Yukos had to pay VAT at the top rate, as if the transactions were domestic. This claim, including interest, fines and penalties associated with it, formed the majority of the overall tax assessment. Isolated from the profits tax aspects, the claim that Yukos used the trading companies in bad faith to avoid a VAT that never should have been assessed seems indefensible.

In essence, the investment tribunals and the Strasbourg Court had to decide whether to credit Russia’s story about its tax law. If the government’s account withstood scrutiny, then Yukos’s assessment represented a legitimate exaction. If not, then one would have to conclude that the Russian authorities contrived a phony debt to enable the government to acquire the company’s valuable assets at no real cost. Either way, the tribunals had to do something about Russian tax law.

What the tribunals did was sharply disagree. The three investment treaty panels refused to accept Russia’s story at face value. They were sceptical that Russian law actually deployed an open-ended doctrine that allowed the tax authorities to reason backwards

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23 Eg Russian Civil Code art 10(1) (forbidding the abuse of civil rights). In 2012, the Russian legislature added art 3 to the Civil Code, which imposes an express good faith on all private transactions.
24 Russian Tax Code art 11(1).
25 Russian Civil Code arts 168–70.
26 Russian Tax Code art 164(1)1.
27 ibid art 165.
from a conclusion that the taxpayer had behaved badly to undo its transactions. They had particular difficulty finding any justification for the VAT outcome.

All three investment treaty tribunals asserted that they did not act as reviewing courts for questions of municipal law. Yet, in concluding that the tax assessment effected an expropriation, they rejected the conclusions of the Russian courts as to the assessment’s legality. Because those courts had not discussed the ‘good faith taxpayer’ argument at any great length, the tribunals did not have to explore in depth the validity or scope of this doctrine. The Russian courts instead relied on the ‘actual ownership’ argument, which the tribunals found inherently implausible.28

The three tribunals’ opinions show a careful review of the opposing parties’ submissions as to the state of Russian law and a considered choice in favour of Yukos’s account. At the same time, they also suggest a working assumption that Russia’s normal assessment practice, the facts of the Yukos dispute aside, did not depart too greatly from what the arbiters understood to be accepted international standards. In particular, they expressed amazement that the Russian authorities would not accept the filings made by the trading companies as adequate to sustain the application of the zero VAT rate to Yukos.

The Strasbourg Court took a different tack. It ruled that procedural aspects of the case, particularly the government’s refusal to allow Yukos to choose what assets to sell to liquidate the claim and the unseemly haste surrounding the auction of YNG, constituted violations of the European Convention on Human Rights. But it refused to question the validity of the tax claim itself.

Having regard to the applicable municipal law, the Court finds that, contrary to the applicant company’s assertions, it is clear that under the then rules contractual arrangements made by the parties in commercial transactions were only valid in so far as the parties were acting in good faith and that the tax authorities had broad powers in verifying the character of the parties’ conduct and contesting the legal characterisation of such arrangements before the courts . . . . In addition, the case-law referred to by the Government indicated that the power to re-characterise or to cancel bad faith activities of companies existed and had been used by the municipal courts in diverse contexts and with varying consequences for the parties concerned since as early as 1997 . . . In so far as the applicant company complained that the bad faith doctrine had been too vague, the Court would again reiterate that in any system of law, including criminal law, there is an inevitable element of judicial interpretation and there will always be a need for elucidation of doubtful points and for adaptation to changing circumstances. In order to avoid excessive rigidity, many laws are inevitably couched in terms which, to a greater or lesser extent, are vague and whose interpretation and application are questions of practice . . . . On the facts, it would be impossible to expect from a statutory provision to describe in detail all possible ways in which a given taxpayer could abuse a legal system and defraud the tax authorities. At the same time, the applicable legal norms made it quite clear that, if uncovered, a taxpayer faced the risk of tax reassessment of its actual economic activity in the light of the relevant findings of the competent authorities. And this is precisely what happened to the applicant company in the case at hand. Overall, having regard to the

margin of appreciation enjoyed by the State in this sphere and the fact that the applicant company was a
large business holding which at the relevant time could have been expected to have recourse to
professional auditors and consultants . . . , the Court finds that there existed a sufficiently clear legal basis
for finding the applicant company liable in the Tax Assessments 2000-2003.29

The Court further found that ‘the relevant rules made the procedure for VAT refunds sufficiently
clear and accessible for the applicant company to able to comply with it’.30

These decisions illustrate both the unavoidability of municipal law in international
adjudication and the range of techniques that a tribunal can use to resolve conflicts over
its meaning. The investment treaty tribunals looked behind the Russian government’s
assertions about the state of its law, weighing the evidence without any presumption in
favour of either party. These tribunals did employ a template based on their sense of
normal international practice and regarded deviations from that standard with suspicion.
Their finding that a treaty violation occurred rested ultimately on determinations that the
tax assessment violated Russian law, notwithstanding the contrary conclusion of the
Russian judiciary.

The Strasbourg Court, looking at the same evidence, approached the municipal law
question differently. It too looked at Russian tax law, because the legal standard it applied
made such an inquiry unavoidable. But rather than undertaking an independent review
of the evidence, it accepted at face value the conclusions of the Russian courts and the
subsequent rationalizations of the Russian government. The Court did not defer to the
Russia government so much as endorse its arguments. This endorsement, however
perfunctory, seems more disturbing than mere indifference. The Court effectively claimed
itself persuaded by arguments that other tribunals, constituted differently, found
inherently implausible.

The Strasbourg Court’s contrasting treatment of the statute-of-limitations issues
illustrates its relative comfort with procedural, rather than substantive issues. The Tax
Code required the government to make a claim for fines and penalties (but not unpaid
taxes) within 3 years of the end of the tax year in question. The Yukos assessment missed
that deadline by 2 weeks, but the Russian courts upheld fines anyway. The issue went to
the Constitutional Court twice. The first time, the Court refused to intervene, arguing
that a single decision by an intermediate appellate court did not constitute a judicial
practice susceptible to constitutional review. The second time, a majority of the Court
concluded that the statute had an implicit exception for instances where the taxpayer
substantially interfered with the authorities’ ability to investigate its tax status.31

30 ibid para 601. On this last point, a later investment treaty tribunal remarked:

[T]he ECHR appears . . . to have entirely missed the point being made, namely that if the tax authorities were going to
attribute to Yukos the transactions carried out in the names of its trading companies, they should also have attributed to
Yukos the submission of normal VAT documentation by the trading companies.

31 Judgment of the Constitutional Court of the Russian Federation Case No. 36-O of 18 January 2005; Resolution of the
Constitutional Court of the Russian Federation in Case No. 9-P of Jul. 14, 2005. The following year, the Russian parliament
amended the Tax Code to confirm the Constitutional Court’s interpretation. Russian Tax Code art 113(11).
On this point, the Strasbourg Court found a violation of the principle of legality. The Constitutional Court’s creation of an exception to an explicit limit on state authority could not have been anticipated by a reasonable observer:

Although the previous jurisprudence of the Constitutional Court contained some general references to unfavourable legal consequences which taxpayers acting in bad faith could face in certain situations, these indications, as such, were insufficient to provide a clear guidance to the applicant company in the circumstances of the present case.\(^{32}\)

Accordingly, it found the imposition of penalties to constitute a violation of the Convention, notwithstanding the Constitutional Court’s rationalization. One might ask why an undefined concept of ‘bad faith taxpayer’ would be sufficient in the eyes of the Strasbourg Court to justify the construction of massive substantive liabilities but not to support a simple tolling of a statute of limitation. One possible response is that statutes of limitations are universal and familiar. The Court had an evident expectation of how they were supposed to operate, and regarded the Russian Constitutional Court’s ad hoc amendment as inconsistent with this expectation. The Strasbourg Court, by contrast, did not have a well-formed notion of how modern tax systems operate or how states promulgate and apply anti-abuse rules.

One also can look at these two lines of decision functionally. The investment treaty tribunals, notwithstanding the conceit that they apply only the treaty, acted as an administrative-law court. They reviewed the behaviour of Russian legal actors, including the judiciary, in light of their understanding of Russian legal authorities. They regarded themselves as competent to address an admittedly difficult, perhaps even intractable issue, namely the line between legitimate tax planning and illegitimate taxpayer opportunism. They had sufficient familiarity with generally accepted tools used by national tax administrators to grapple with this problem, such as transfer pricing regulation and adequate VAT documentation, to understand that what Russia had done departed greatly from this international practice. They did, in short, what a free and independent Russian judiciary most likely would have done, if the case had not been subjected to overriding political interest.

The Strasbourg Court, although addressing the same issues and relying on essentially the same evidence, did much less, but not nothing. It saw itself as competent to challenge municipal law only to the extent that this law concerned general and non-technical issues. Rather than reinforcing the rule of law as a whole, it focused on only a few targeted areas. It behaved more like a national constitutional court of limited jurisdiction, one that regarded most regulation of business activity as beyond its remit. The decision reminds one a bit of the early New Deal U.S. Supreme Court, which for a time was exceedingly deferential to the administrators of economic regulation.\(^{33}\)

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\(^{32}\) OAO Neftyanaya Kompaniya Yukos v Russia, [2011] ECHR 14902/04 at para 573. The seriousness with which the court regarded this procedural violation is indicated by its subsequent determination of damages owed. It ordered Russia to pay over a billion euros to the Yukos Foundation, the expatriate legal successor of the company, to compensate for the injuries caused by the statute-of-limitations ambush as well as excessive fees assessed as part of the enforcement proceedings. OAO Neftyanaya Kompaniya Yukos v Russia, [2014] ECHR 14902/04, 31 July 2014.

\(^{33}\) Eg J.E. Riley Investment Co. v Commissioner, 311 U.S. 55 (1940).
Both forms of international adjudication reviewed municipal law. The investment treaty tribunals did so comprehensively; the Strasbourg Court acted selectively. The former offers a model for international review of national business regulation. The latter is more complex: the review extended by the court, being cursory, has the effect not of delimiting areas of regulatory autonomy, but of endorsing regulatory decisions, however dubious. Which approach offers better prospects for economic growth and development is considered below.

3. International arbitration as substitute and complement

Review of municipal law is an inevitable part of the enforcement of international law, whether under an investment or human rights treaty. The questions become whether the tribunal sets boundaries around the subjects it will review carefully, and how the tribunal carries out enhanced as distinguished from pro forma review. Finding answers rests on many factors, including the institutional capacity of the tribunals, the quality of the bar that appears before these bodies, and the underlying policy goals that motivate the construction of these bodies of international law. I will focus here on only one consideration, namely the dynamic relationship between international and municipal law enforcement institutions.

Theorists have proposed two accounts of this relationship. One version sees municipal and international legal regimes as complements. Competition between the two systems leads each to maximize its value to its users. The other version sees the two regimes as substitutes. Preferred investors abandon municipal dispute resolution in favour of the international regime. Without a constituency for reform, the municipal system declines. The first account meets most of the extra-layer objections to investment arbitration; the second account reinforces the criticism. Each requires some unpacking.

The complement account requires a mechanism that enables competition between the two systems. Both systems must seek to attract the same or overlapping business. In addition, each system must have the capacity to respond to consumer demand. Finally, they must offer sufficiently like products.

When competition exists, trial and error will teach each system what consumers prefer and each will seek to provide that service at a higher quality and lower cost. This competition will be socially valuable to the extent that consumer preferences align with social welfare. In the case of a dispute resolution system, this is not completely straightforward, because every disputant would regard a fair, disinterested and informed system as second best to one that always makes that disputant a winner. If, however, a range of disputants with different interests—say, investors and government regulators—have equivalent access to each system, then presumably competition will drive the two regimes towards providing what most participants would regard as second best, but what society would regard as an optimal outcome, namely an effective, disinterested and social-welfare promoting dispute settlement regime. To the extent the dispute resolution

34 See Ginsburg (n 8) 118–19.
system generates reliable information about the future actions of tribunals (i.e., precedents), the consumers would include all persons considering business transactions who might face a potential grievance against the government, not just the class of treaty-protected investors. The complement account thus is a virtuous rule-of-law story based on social welfare.

This argument further assumes, of course, that enforcement of the rule of law as a check on governmental discretion benefits society as a whole. Some might argue that uncertainty about the future mandates that the government retain sufficient discretion to deal effectively with unanticipated regulatory problems. The rule of law, to put the point grandiosely, should not become a suicide pact. But uncertainty about the government’s power to respond effectively to unanticipated crises still might be superior to certainty about the government’s unfettered discretion, crisis or no crisis.

The substitute story, by contrast, starts by challenging at least some of the assumptions on which the complement story depends. Municipal courts might, for example, prefer less work, especially if measures to attract more business would attract retaliation from locally powerful actors or other costs. In the most pathological case, locally powerful actors might prefer ineffective municipal law enforcement organs so as to avoid obstacles to appropriation of assets belonging to the state or other, less powerful, persons.35 The same actors might seek to secure title to assets acquired under dubious circumstances by relying on an international dispute resolution system that they can invoke against counterparties and the state, but that the state cannot invoke against them. Round-trip asset transfers, coupled with a liberal definition of a ‘foreign’ investor, might give them access to this system.36 Even in less malign circumstances, local courts might not have a strong incentive to attract those disputes that are eligible for international adjudication, if they preferred leisure to whatever benefits might compensate for more work.

Without effective competition between the two systems, those persons with the resources and legal status to do so would flee to quality. Foreign investors (including local persons able to structure investments through foreign entities) would always use investment treaty arbitration rather than local courts. Lacking the support of those persons most interested in strong private law rights, the local courts would become weaker, more susceptible to official interference and corruption, and less willing to reach controversial outcomes. The rule of law would suffer.

Social scientists have not yet conducted comprehensive studies of the effect of alternative international dispute resolution, particularly investment treaty arbitration, on the quality of local legal institutions. The one preliminary study of which I am aware reached inconclusive results.37 Any empirical analysis is complicated by the likelihood that, as discussed above, at least one of the treaty parties had weak legal institutions before entering into the relationships. Measuring any impact, good or bad, is hard. One

36 D Nougayrède, ‘Outsourcing Law in Post-Soviet Russia’ (2014) 7 JEL.
37 Ginsburg (n 8) 120–22.
would anticipate a substantial lag in the effect, yet causation becomes increasingly
difficult to measure as the interval between the proposed cause and the measured effect
increases and becomes subject to environmental noise.\textsuperscript{38}

What we are left with, then, is considerable doubt about the instrumental effect of
international adjudication. But tribunals must make choices, even when they do not
know their consequences. As the Yukos cases illustrate, a tribunal must do something
about municipal law. Careful and searching review is one option, and cursory
endorsement of the government’s position is another. In deciding to take one path
rather than the other, the tribunal must consider whether its actions encourage
substitution or complementarity.

In theory, a tribunal convinced that effective execution of its task would only
undermine the rule of law in the host country might look for ways to sabotage its work.
This outcome, however, seems implausible. First, one doubts that arbiters dedicated to
sabotage would get much repeat work (an argument that does not apply to members of a
permanent body such as the Strasbourg Court). Second, the tribunal cannot do nothing.
Diffident endorsement of the government’s version of municipal law, the alternative to
effective execution, would undermine further whatever forces for reform might exist in
the country in question.

A variation on this position might stress the argument, popular in academic circles,
that membership in a treaty regime itself induces needed reform in the treaty parties, but
only through a gradual process of socialization.\textsuperscript{39} However cynical a government’s
motives in joining a regime, the argument maintains, ongoing interaction with treaty
parties and the institutions that the treaty creates over time will induce a state to aspire to
meet the treaty’s standards. A tribunal convinced of this rational would regard its
foremost objective as not antagonizing the state in question to the point where it would
consider withdrawing from the regime.

A generous appraisal of the Strasbourg Court’s behaviour in the Yukos case might see
it as acting in accordance with this last perspective. The benefits from keeping the Russian
government in the Convention regime might outweigh the immediate cost of seeming to
endorse a highly dubious exercise of bureaucratic and judicial discretion. Seen in this
light, the ruling seems wise, not craven or obtuse.

The socializations story, however, may be a bit too convenient. It allows the tribunal
(and its supporters in practice and academia) to assume the greatest beneficence while
taking a path that involves little risk or effort. It also overlooks the possibility that
passivity in the face of the government’s misconduct might undermine the supposed
socialization process.

Why might tribunals instead see their work as complementing municipal legal
institutions? Arbiters might believe that, whatever the short-term effect of international

\textsuperscript{38} For a review of the legal origins literature that seeks to identify a causal effect over lengthy intervals between legal institutions
and economic development, see R La Porta, F Lopez-de-Silanes and A Shleifer, ‘Economic Consequences of Legal Origin’ (2008) 46

\textsuperscript{39} R Goodman and D Jinks, Socializing States—Promoting Human Rights Through International Law (OUP 2013) passim.
adjudication on the municipal legal system, acting as if international and municipal dispute resolutions were complements is unlikely to do much harm and, over the long run, may do some good. In reviewing the actions of municipal courts, the tribunal could promote both transparency and accountability. Domestic actors might resent the scrutiny, but credible and disinterested criticism is not likely to encourage them to do even worse. The tribunal’s review also could bolster the efforts of such municipal law reformers as exist by validating their concerns about the domestic rule of law.

This argument points towards a robust review of municipal law in international adjudication, once treaty commitments have come into being. States that have committed to this form of dispute resolution should be presumed to expect and desire an objective and informed review of municipal law, more or less along the lines of Chapter 19 of NAFTA and the diversity and alienage jurisdiction of US federal courts. Tribunals should not use the accident of their jurisdiction as an excuse to improve municipal law. But they should embrace the argument that unanticipated changes in municipal law, if harmful to persons who enjoy rights under a treaty, can constitute violations of those rights.

Symmetrically, states deciding whether to enter into such treaties, or contemplating whether to stay in a regime, should consider their options in light of this presumption. A state that believes that it can best promote and improve its municipal legal institutions by forcing those bodies to accept greater responsibilities might begin by protecting them from competition. Protectionism would include a refusal to consent to international adjudication and resistance to the domestic recognition and enforcement of foreign judgments. Such states presumably would bolster this protection with tighter regulation of flight capital, so as to ensure that local entrepreneurs have no alternative to the domestic system.40

4. Conclusions

Consider again the extra-layer critique of international investment arbitration. If international adjudication encourages the deterioration of municipal legal institutions, the charge would be well founded. Those who can qualify for international protection, including those able to structure local business activities through foreign holding companies, would have a competitive advantage over their domestic competitors. The treaties would function as a mechanism to distribute rents to the powerful at the price of stymied development.

If, however, legal review of government misconduct both functions as a public good and a process that can generate private benefits for influential groups such as lawyers, inducing international and municipal legal institutions to compete for business may lead to a virtuous cycle of stronger rights and security, with increased prosperity as a consequence. Complementarity between international and municipal institutions might drive both to do their jobs better. The public would gain from the result.

40 For discussion of the multiple failures of the Russian Federation to take such measures, and an at least implicit endorsement of some controls in circumstances such as Russia faced in the 1990s, see D Nougayrède (n 36).
The *Yukos* episode provides at least some support for the complementarity story. The ability of Russian oligarchs to employ foreign, largely British, legal institutions may have contributed to the weakening of the already poor Russian legal system, but one cannot credibly argue that access to international investment law deterred the development of municipal law. Coverage of these international regimes was and is too limited, and the mechanisms for converting their awards into actual compensation too weak, to induce anyone to disregard domestic reform.

Instead, these international regimes offered the prospect of an external and disinterested critique of abuses of government power, critiques that local reformers could in turn use for their own purposes. Investment treaty arbitration brought focus and credibility to arguments that the Russian government, in attacking a particularly unpopular figure, traduced rights that generally benefit society as a whole. Moreover, because the source of the criticism is an impartial international tribunal rather than a foreign national organ, the Russian authorities cannot dismiss it on nationalist grounds.

None of this put the extra-layer criticism to rest. Without well-designed and extensive quantitative analysis of the impact of international adjudication on the domestic rule of law, no one will be in a position definitively to resolve the argument. This article, however, does illuminate some of the underappreciated benefits of robust review of municipal law in investment treaty arbitration. Such review both makes it more likely that the parties to such treaties will get the benefit of their bargain, and that states contemplating whether to join such regimes will understand the consequences of their decision.