The Principle of Good Faith in The Choice of Law of Foreign Direct Investment Contracts in Indonesia

Rizky Amalia  
Faculty of Law, the University of Airlangga  
rizky.amalia@fh.unair.ac.id

Hilda Yunita Sabrie  
Faculty of Law, the University of Airlangga  
hilda.sabrie@fh.unair.ac.id

Widhayani Dian Pawestri  
Faculty of Law, the University of Airlangga  
widhayanidian@fh.unair.ac.id

Abstract  
Applying the principle of good faith in the choice of law is one of the most common problems of international business contract, particularly in foreign direct investment contracts. The implementation of the principle of good faith in the choice of law increasingly reduced by the emergence of some problems in the investment contract, which of course, the most aggrieved entities are domestic investors who also host country. The choice of law has an important role in the contract because it concerns the interests of each of the parties, and the principle of good faith as a priority principle of international contract law should be applied as the basis for determining the choice of law for the parties to a contract. This paper examines the principle of good faith in the choice of law to realize justice among the parties with different laws, especially on private and public investment contracts between foreign investors and domestic investors in Indonesia, in the process of formation, implementation, or post-contract. This paper is legal research that is normative, meaning that this research is based on the prevailing laws and regulations in Indonesia. Then, the approach used is
statute approach and conceptual approach. So it is expected that between the rules and the concept of existing topics will be aligned.

Keywords: Choice of Law, Foreign Direct Investment Contracts, Principles of Good Faith.


DOI: https://doi.org/10.25041/fiatjustisia.v12no2.1306

A. Introduction

Applying the principle of good faith in the choice of law is one of the most common problems of the international business contract, particularly in foreign direct investment contracts. The implementation of the principle of good faith in the choice of law increasingly reduced by the emergence of some problems in the investment contract, which of course, the most aggrieved entities are domestic investors who also host the country. This paper examines the principle of good faith in the choice of law to realize justice among the parties with different laws, especially on private and public investment contracts between foreign investors and domestic investors in Indonesia, in the process of formation, implementation, or post-contract.

As a developing country, Indonesia's bargaining position is often an imbalance with the host country, Sornarajah:¹

*Another feature of bilateral investment treaties is that they are made between unequal partners, they entrench an inequality that has always attended this area of international law, and they are usually agreed between a capital exporting developed state and a developing country state keen to attract capital from that state.*

Other developing countries also feel the imbalance bargaining position of the host country. The principle of international trade adopted, such as the Most Favored Nation (from now on referred to as MFN) contained in Article 1 paragraph (1) of GATT, assumes that each country has equality, but the facts show there is no equality among developed and developing countries. Thus, when the MFN principle remains enforced, it will be contrary to the GATT goal itself, namely the achievement of "mutually advantageous arrangements." The imbalance bargaining position between host and house country developed and developing country, requires the parties to apply the

principle of good faith as a principle put forward in contract law in the international arena as the basis for determining the choice of law, because the choice of law has an important role in a contract.

B. Discussion

In the public sector, the international investment agreements are principally one of the sources of International law under Article 38 (1) of the Statute of the International Court of Justice. In Article 38 (2) of the Statute, there are several sources of law of the international investment law, such as a treaty, customary international law, general principles of law, and judicial decisions.\(^2\) The customary international law, as well as the international investment agreements, are the source of the birth of the legal principle of the investor protection within the framework of the international investment. Consequently, state responsibility will be born if host states violate the rights of investors protected under customary international law or international investment treaties.\(^3\)

International customary law develops as an international minimum standard of treatment and International minimum standard of protection.\(^4\) The traditional idea of diplomatic protection and treatment of foreigners (treatments of aliens) are customs accepted as an international customary law that is the basis of protection of foreign investment. The general principles that have been accepted as examples are the principle of consent, reciprocity, equality of states, the finality of awards and settlements, the legal validity of agreements, good faith, domestic jurisdiction, and the freedom of the seas.\(^5\) Other principles that are also internationally acknowledged are national treatment, most favored nation treatment, pacta sunt servanda and rebus sic stantibus.

The contents of substantial international investment agreements in bilateral, regional and multilateral forms provide more protection for the interests of investors. The formulation of the protection of substantive investor rights such as MFN, NT, Full Protection and Security, indirect expropriation, etc. is more open (open-ended) and not definitively defined. This provides an opportunity for arbitrators within the arbitration body to


provide a very broad interpretation that will result in broadening the scope of protection for the interests of investors.

In some cases, the Government of Indonesia issued by foreign investors through Investor-State Dispute Settlement (from now on referred to as ISDS) resulting in conflict between the host country and house country, as according to foreign investors, the policies made by the Indonesian government are harming them. The settlement of investment disputes through the Investor-State Dispute Settlement (from now on referred to as ISDS) is often described as a form of legal protection that leads to the protection of one-sided interests that protect the legitimate expectation of investors rather than the public interest of the host state. As a result, the settlement of investment disputes puts more emphasis on protecting the economic interests of the investors by ignoring the protection of the public interest of the host states.6

About the Indonesian government’s appeal by foreign investors, the international court has interpreted the application of fair and equitable treatment principle. The principle of reasonableness is an important principle in the Fair and Equitable Treatment Principle.7 In the principle of reasonableness, the recipient country is required to have clear reasons and objectives in making policy. The principle of reasonableness is applied in the case of the Government of Indonesia with PT. Newmont Nusa Tenggara and also PT. Churchill Mining. In practice, the principle must be proven, that the clear reasons and objectives of the Indonesian government for the policy are clear and acceptable even for Indonesian government investors have no good reason for the policy. However, if the purpose or reason for the creation of a policy is based on political or other objectives, then the policy will not be justified.

Indonesia is one of the countries whose laws are always growing following the development of the society. One of them is the field of contract law that has developed both for domestic contract and international contract. The existence of these developments is due to the increasing variety of contracts made by parties to meet their needs. Indonesian society is part of the international community, where the legal act is done, then it should pay attention to international aspects especially related to international business transactions. According to the nature and scope of the law, binding contracts are differentiated into national contracts and international contracts. A national contract is a contract whose parties have no foreign element, while an international contract is a contract in which there is a foreign element. The role of contract law today is central as Atiyah

---

states it:\textsuperscript{8} that is, with the increasing product produced by the work resulted in the increase of the transition of the product from one person to another; and with the increasing role of financing institutions increasingly encouraging people to conduct business transactions, the role of the contract is increasingly perceived.

Theoretically, the foreign element that can be an indicator of an international contract is a foreign element that is: different nationalities; the parties have legal domicile in different countries; the law chosen is foreign law, including the rules or principles of international contracts against the contract; dispute settlement of contracts is held overseas; the execution of such contracts abroad; the contract is signed overseas; the object of the contract abroad; the language used in the contract is a foreign language; and the use of foreign currency in the contract. The above elements are indicators of a contract categorized as an international contract. The indicator is a link point that is a foreign element. The foreign element makes the contract an international contract. The foreign element in the contract is the determinant of such a contract is a domestic contract or an international contract.

Similarities and differences are found in the legal sources used in both domestic and international contracts of different traits. The source of domestic contract law must use a source of law sourced from domestic law, but international trade contracts not only refer to domestic law alone. The source of the law can be classified into 7 (seven) legal forms as follows:\textsuperscript{9} national law (including the legislation of a country either directly or indirectly related to the contract); contract documents; customs in the field of international trade related to contract; general legal principles of contract; court ruling; doctrine; and International agreements (concerning Contracts). These sources can be used as a reference in the process of forming a contract. The dynamics of business relationships that engage interstate businesspeople, in particular, international commercial contracts, have led to the development of contract law that adopts the universal principles developed in custom practice (\textit{lex mercatoria}).\textsuperscript{10}

\textit{Lex Mercatoria} is also referred to as "\textit{the Mercantile Law}" or "\textit{the Law of Merchant}," which in the Black's Law Dictionary is formulated as follows:

"... a system of customary law that developed in Europe during the Middle Ages and regulated the dealings of mariners and merchants in


\textsuperscript{9} Ibid., p. 69

all commercial countries of the world until the 17th century. Many of the Law Merchants' principle came into the form of the common law, which in turn formed the bassist of the Uniform Commercial Code".

Lex Mercatoria is defined as a customary law in business practices (not written) which was originally applicable among traders. The development of lex mercatoria makes these unwritten trades habits to be written through the judgment of commercial judges, arbitrators, standard contractual clauses even institutionalized through the international organizations, such as the International Chamber of Commerce (ICC), FIDIC (Federation Internationale Des Ingenieur's Counsels), UNCITRAL (United Nations Conference on International Trade Law) and UNIDROIT (International Institute for the Unification of Private Law). About the investment contract, in the formation and the implementation of the contract also comes from lex mercatoria, especially in the field of investment law.

The principles in domestic contracts also apply to the international contracts. The fundamental difference between both is the existence of a principle of autonomy of the parties where it underlies the choice of law and the choice of forum applicable to the contract they make. The principles of contract law in the opinion of M.Isnaeni cited by Agus Yudha Hernoko, among others: 11 the principle of freedom of contract; the principle of pacta sunt servanda; the principle of equality; the principle of privity of contract; the principle of consensual; and the principle of good faith. The principles underlie the formation of contracts in Indonesia, both domestic and international.

The main legal source that becomes the legal guidance of contract in Indonesia is Burgerlijk Wetboek (BW), but in the Netherlands, BW has been developed and changed into Nieuw Burgerlijk Wetboek (NBW). In NBW some arrangements on contract law have evolved, including the following legal principles governing: the binding force of contract, that contracts not only bind the parties to what is expressly agreed upon but also whereby their nature, determined by legislation, customs, and propriety (principle of contract binding power as defined by the substance of Article 6: 248 paragraph 1 of NBW); the principle of freedom of contract, that the parties bind themselves with: any party, content or substance, form or format, and the law applicable to them; and the principle of consensual, the contract is based on the agreement of the parties with any form or format. The principles mentioned above have a very important function both in the formation, implementation and in settlement of disputes that occur in the future by the parties.

---

The principles of the law of obligation have become the principle applicable as International Contracts Custom, for example *pacta sunt servanda; good faith; rebus sic stantibus*. All contracts made must be in good faith so that the contract applies as a pacta sunt servanda to the parties who make it. The special character of the international contract is the existence of a principle of autonomy of the parties by which the parties decide which law shall apply to the contract. One of the principles whose limits are difficult to determine as the principle of good faith. The principle of good faith is contained in Article 1338 paragraph (3) BW which emphasizes the necessity for the parties to carry out the contract in good faith.

In line with the development of the times, this provision is interpreted extensively (extensive interpretation) which then resulted in the provision that good faith applies not only at the stage of implementation but also at the stage of signing and stage before the closing of the agreement (pre-contractual phase). Civil law in Indonesia where the main source is BW also contains good faith as a foundation regarding mastery. Black's Law Dictionary is defined of good faith “a state of mind consisting in (1) honesty in belief or purpose, (2) faithfulness to one’s duty or obligation, (3) observance of reasonable commercial standards of fair dealing in given trade or business, or (4) absence of intent to defraud or to seek unconscionable advantage”. The principle of good faith becomes an important foundation in the agreement because all agreements must be based on good intention. The agreement should not be based on bad intention or bad faith. The principle of goodwill is historically derived from the civil law system rooted in Roman law. Goodwill is also reflected by the strong and deep desire of two parties to bind them in the agreement. The principle of good faith which originally applies only to the contract law has now developed and accepted as a principle in other areas of law, both private and public law. Goodwill in the BW can be found in Article 1338 (3), which provides that "agreements shall be executed in good faith." The good faith of this Article is for the agreement either in the process of formation or pre-agreement until the stage of execution of the treaty or post-agreement.

The investment contracts reviewed in this paper are contracts that may fall within the category of private contracts as well as public contracts. The difference is in the parties, and also the source of the law used. When the investment is made under a Public Private Partnership scheme, the contract category is within the scope of a public contract in which the freedom of contracting parties to determine the form and content of the contract is limited to the laws of the country in which the contract is exercised. Not only that, the principles that apply in the field of investment must also be paid attention to by contractors. When juxtaposed with private contracts where there is no public element to be a party to the contract, so the principle of freedom of contract, in this case, is more widely applicable. If there is a foreign element in the contract, then the choice of law is possible to be determined by the parties. The determination of this choice of law is based on the principle of autonomy of the parties to which the parties are given the authority to self-determinate the law to apply in the contracts they make.

The clause of the law is a clause in the contract in which the parties declare the choice of a legal system governing the contract. There are several terms used for the choice of law among others: Partij-autonomie (in Dutch), Heranziehungsvertrag (in German), loi d'autonomie (in French), the intention of the parties (in English), and contratto in collagamento (in Italian). The term choice of law is more definitive than the autonomy party. Schitmitthoff defines the choice of law is already common, and all parties respect the existence of a choice of law in the contract. The choice of law has several functions among others:

a. To determine what law will be used to determine or explain the terms of the contract or law that will determine and regulate the contract.

b. Avoid the legal uncertainty applicable to the contract during the implementation of the contractual obligations of the parties.

c. Choice of law also serves as a source of law when the contract does not regulate something.\(^{16}\)

In the preparation of the international contracts, the choice of law is important because not all foreigners are happy if its approval is regulated and interpreted under Indonesian law.\(^{17}\) The parties have autonomy in negotiating, selecting, determining or agreeing on which legal rules will be included in the treaty and applicable to legal consequences as well as the possible future settlement of disputes.

The principle of party autonomy, when juxtaposed with the principle of freedom of contract, has a different role. The principle of party autonomy is the basis for contracting parties to choose what law is enforced in the


contract. The law is chosen by the parties' agreement that underlies the parties to pour their business wills into a contract. The existence of these will is based on the principle of freedom of contract in which the parties are free to make the form or content of the contract. Both principles certainly have limits. Restriction on the principle of freedom of contract contained in Article 1338 paragraph (1) of the BW makes the principle of freedom of contract not be absolute. Such restrictions may be found in Article 1338 (1) framed by other articles within a framework of the legal system of contract (vide Articles 1320, 1335, 1337, 1338 (3) and 1339 BW) in the form:\(^{18}\)

- a. Fulfill the terms of the validity of the contract;
- b. To achieve the parties' objectives, the contract must have a causa;
- c. Does not contain false causes or is prohibited by law;
- d. Not contrary to propriety, custom, decency, and public order;
- e. Must be done in good faith.

Similarly, the principle of freedom of contract to the principle of autonomy of the parties in determining the choice of law and the choice of the forum also has limits. Choice of law can be analogized to glasses, if we use glasses with green lenses, then everything will appear to be green.\(^{19}\) This implies that when the choice of law has been determined, the law applied to the contract is the choice of law which was chosen by the parties. The choice of law may be expressly stipulated by the parties in a clause, the choice of law secretly or implied, or the choice of law under the agreement of the parties to submit the choice of law to the court. If the parties do not determine the choice of law in the contract they make then; there are several theories that can be used by judges, among others: *lex loci contractus, lex loci solutionis, lex loci execution*, the proper law of the contract, and the most characteristic connection. Indonesian private international law has not developed. The Netherlands has made progress with the NBW Book 10 which specifies the Private International Law. Article 157 NBW mentions for contracts that include the scope of international civil law subject to Regulation Rome II.

One of the principles underlying the choice of law is that the choice of law is generally accepted.\(^{20}\) The choice of law is common and acceptable, so everyone can decide for themselves the law applicable in the contract they make, and the choice must be respected. Parties controlled by the same legal provisions by themselves are also subject to the same law, and hence do not

---

apply the principle of choice of law. The choice of law and the choice of forum are two different things, but they are related to each other. The choice clause of law and the choice of forum are an important clause in international trade contracts wherein the contract involves the law of different parties. The basis for determining the choice of law and forum choice of an international trade contract is the agreement of the parties which is the embodiment of the principle of party autonomy. The selection of forums and options of law is not unlimited but has certain limitations, such as public order, mandatory rules, contractual relationship, and good faith.

C. Conclusion

The principle of good faith underlying the parties in the choice of law can be seen from the fairness of the parties choosing a law to regulate their contractual relations. In good faith, there is an obligation to behave appropriately, as well as in propriety contained duty to good faith. Therefore, a choice of law that violates the good faith principle has its legal effect in its application. The Choice of law and the choice of the forum have some differences. The choice of law is used to choose the law which used for the settlement of disputes between the parties to the contract, while the choice of forum is used to choose the forum. Both are related to each other. The basis of the choice of law and the choice of the forum of a contract is the agreement of the parties which is the application of the principle autonomy of the parties. The choice of law and the choice of the forum have some limits such as public order, mandatory rules, contractual relationship, and good faith.

Bibliography

A. Books


The Principle of Good Faith in the Choice of Law of... Rizky A, Hilda Y S, and Widhayani D P


B. Legislations

Agreement Establishing the World Trade Organization (WTO)

Burgerlijk Wetboek Voor Indonesie

Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID)

Republic of Indonesia Law No. 25 on 2007

Republic of Indonesia Law No. 30 on 1999

Republic of Indonesia Law No. 5 on 1968

Republic of Indonesia Law No. 7 on 1994

Republic of Indonesia Law No. 7 on 2014


UNCITRAL Model Law

UNIDROIT Principles of International Commercial Contract

C. Other Resources

