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Chapter 1

Investor-State Arbitration: An Increasingly Powerful Tool For Resolving Disputes With Sovereigns

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Introduction

International arbitration has long been an important mechanism for resolving disputes between private commercial interests. It is increasingly becoming a powerful tool for resolving disputes with governments, too, thanks to the ever-growing number of international investment agreements around the globe and a growing body of international law that has interpreted these agreements expansively. Investors and corporate counsel would be wise to consider these recent developments, so as to take full advantage of investment agreements when structuring international business transactions and when handling investment disputes with sovereigns.

Investment agreements most often come in the form of a bilateral investment treaty or "BIT". But they can also be part of a larger multilateral agreement, such as NAFTA or the Energy Charter Treaty. The last decade has seen remarkable growth in the number of such agreements. By the end of 2004, there were nearly 2,400 BITs in existence worldwide, up from roughly 1,100 ten years earlier (U.N. Conference on Trade and Development, IIA Monitor No. 4 (2005) UNCTAD/WEB/ITE/IIT/2005/2, at 3 n.7). Not surprisingly, the number of investor-State disputes has also soared, with the known number of treaty-based cases rising over this same time period from less than 10 to nearly 220 (*Id.* at 1).

Investment agreements are designed to encourage foreign investment by guaranteeing foreign investors a layer of legal protection above and beyond that provided by the host State's laws. Equally important, they ensure a neutral, international forum for resolving disputes with government entities, allowing foreign investors to bypass the local courts when such disputes arise -- a particularly valuable benefit in countries with biased, unreliable, or inefficient judicial systems.

In a nutshell, the standard international investment agreement has three components:

1. <u>Broad definition of "investment"</u> -- Most modern investment agreements contain a broad and open-ended definition of "investment". They typically provide a non-exclusive, illustrative list of examples of "investments," which can include everything from debt and equity interests; to liens, loans and licenses; to all forms of tangible or intangible property, including intellectual property; to contract rights. Virtually any kind of business activity and presence in a foreign State could at least potentially fall within the ambit of a typical investment agreement.

2. <u>Substantive obligations</u> -- Three obligations are common currency in nearly all investment agreements:

- *National Treatment* -- protects foreign investors and their investments against discriminatory treatment.
- *Expropriation* -- prohibits the direct or indirect nationalisation or expropriation of foreign investments without full compensation.
- *Fair and Equitable Treatment* -- establishes an absolute minimum level of treatment for foreign investors and their investments. It protects foreign investors against fundamentally unfair or arbitrary government actions including, among other things, denials of justice in the courts.

Importantly, the host State may be held liable for breaches committed by any branch of government (executive, legislative, or judicial) and at any level of government (federal, State, provincial, or local). Thus, for example, the challenged measure could be a law, a regulatory decision, a court judgment, or a municipal government's denial of a license or permit. And, under many (but not all) investment agreements, even ordinary breaches of contract by government entities may be actionable and subject to arbitration.

3. <u>Investor-State dispute mechanism</u> -- If the foreign investor suffers injury or loss as a result of a breach of the investment agreement, the investor may bring a claim directly against the host State before an arbitral tribunal, typically seeking money damages as the remedy. The arbitration is final, binding and subject to limited, if any, review in domestic courts. The investment agreement will typically specify one or more arbitral institutions, such as the International Center for Settlement of Investment Disputes (ICSID), or ad hoc arbitration (usually pursuant to the UNCITRAL Rules), that will establish the basic procedures for the arbitration. Investors and corporate counsel will want to pay close attention to the exact terms of the investor-State mechanisms in the investment agreements they are dealing with, as they can differ in crucial respects from agreement to agreement. Some investment agreements, for example, contain a so-called "fork-in-the-road" provision, which precludes arbitration if the investor has already commenced an action in the local courts. Other agreements allow investors to pursue arbitration and local remedies simultaneously.

As the number of investment agreements and investor-State claims has proliferated in recent years, a growing body of

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international investment law has evolved. This article highlights some of these recent developments -- on topics ranging from investor standing, to most favoured nation treatment, to fair and equitable treatment -- and explains why they make investor-State arbitration an increasingly powerful tool for investors and corporate counsel.

Expansive Standing Recognised for Minority Shareholders and Indirect Investors

Recent cases have shed further light on who has standing to bring an investment agreement claim. A hypothetical example will help illustrate the significance of these decisions.

Let's say a company incorporated in State A ("Acme, Inc.") undertakes a project in State B, pursuant to a concession agreement with the government of State B, to modernise State B's telecommunications infrastructure. When elections in State B produce a change in administration, the new government arbitrarily repudiates the concession agreement for purely political reasons. One hundred million dollars worth of investments in State B are for naught, and the concession agreement is rendered worthless. Acme could bring suit against the government in local courts, but State B's judicial system has been plagued with corruption and political influence, making it a highly unpromising forum. Luckily, State B has a BIT with State A.

Who has standing to bring a BIT claim against State B? Certainly Acme does. Acme is an "investor" of State A; it has made an "investment" in State B; and both it and its investment have been injured by State B's treaty breach.

Indirect investors. What if, as is often the case with such projects, Acme had established a wholly owned subsidiary corporation in State B to operate its business there ("Beta Co."), and it was Beta, not Acme, that contracted with the government of State B? Would Acme still have standing to bring a BIT claim against State B? The answer, of course, depends on the BIT in question, which would need to be scrutinised carefully. But, under the typical BIT, there is little question that Acme would have standing as the 100 percent shareholder of Beta (*See, e.g., Impreglio S.p.A. v. Islamic Republic of Pakistan* (ICSID, Decision on Jurisdiction) (Case No. ARB 03/3) (April 22, 2005) at Para. 164, 184).

Indeed, the case law indicates that Acme would have standing even if the telecom concession was with a subsidiary corporation of Beta's. In several recent decisions, tribunals have upheld standing for investors that were several steps removed in the chain of corporate ownership from the entity that was most directly affected by the government's actions. (*See, e.g., Enron Corp. and Ponderosa Assets, L.P. v. The Argentine Republic* (ICSID, Decision on Jurisdiction) (Case No. ARB/01/3) (August 2, 2004); *Siemens A.G. v. The Argentine Republic* (ICSID, Decision on Jurisdiction) (Case No. ARB 02/8) (August 3, 2004); *Azurix Corp. v. The Argentine Republic* (ICSID, Decision on Jurisdiction) (Case No. ARB 01/12) (December 8, 2003).) As one tribunal construing the Germany-Argentina BIT to cover "indirect investments" explained, "[t]he treaty does not require that there be no interposed companies between the investment and the ultimate owner of the company" (*Siemens, supra*, at Para. 137).

Minority shareholders. What if Acme merely owned a minority stake in Beta? Would it still have standing? Recent decisions confirm that generally speaking - and depending on the exact wording of the BIT at issue - the answer would be "yes".

Minority shareholder standing was squarely upheld, for example, in an ICSID case that ultimately resulted in an award of more than $133 million to a U.S. investor who had sued Argentina for damages arising out of the government's response to the economic crisis of 2001-2002. (*CMS Gas Transmission Co. v. The Argentine Republic* (ICSID, Decision on Jurisdiction) (Case No. ARB/01/8) (July 17, 2003).) CMS Gas Transmission Co. ("CMS"), an American company, had acquired a 30 percent equity stake in Transportadora de Gas del Norte ("TGN"), an Argentine State-owned energy company that had recently been privatised. CMS alleged that Argentina's severe financial measures (including new foreign exchange rules, which prohibited gas companies from calculating tariffs in dollars) destroyed its investment in TGN, whose domestic revenues decreased by approximately 75 percent. Accordingly, CMS brought a claim against Argentina under the U.S.-Argentina BIT, asserting, *inter alia*, violations of fair and equitable treatment and expropriation.

Argentina contested jurisdiction, arguing *inter alia* that CMS lacked *jus standi* because it was merely alleging indirect damages resulting from its minority stake in TGN. The Tribunal squarely rejected this argument. It noted that nothing in the BIT, the ICSID Convention, or international law requires the claimant to own, control, or hold a majority of shares in an enterprise; the claimant must only be an "investor," and being an investor can take many forms, including being a minority shareholder. (*Id*. at Para. 48, 51, 63-5.) For a similar result, *see Lanco International, Inc. v. The Argentine Republic* (ICSID, Decision on Jurisdiction) (Case No. ARB/97/6) (December 8, 1998).

Bondholders and other non-equity investors. What if Acme were merely a bondholder and held debt rather than equity in Beta? Could it bring a BIT claim as a creditor rather than as a shareholder? Almost surely the answer would be "yes". Under the sweeping definition of "investment" found in the typical BIT, any investor of State A who had made any form of "investment" in Beta, and whose investment had suffered injury attributable to State B's treaty breaches, would have standing, including bondholders.

Locally-incorporated entities under foreign ownership or control. Is it clear that Beta, a company incorporated under the laws of State B, would not have standing to bring its own BIT claim against State B? Not necessarily. Many BITs have a provision that allows a locally-incorporated company, which is owned and/or controlled by an investor of the other contracting State, to step into the shoes of a foreign investor for purposes of bringing a BIT claim. If the BIT between State A and State B had such a foreign ownership/control clause, Beta would be able to bring a claim against State B on its own behalf.

Lessons for investors and corporate counsel. Investors and corporate counsel should carefully consider recent developments regarding standing, both when structuring business transactions and when contemplating bringing claims under an investment agreement. For instance, investors and corporate counsel should examine whether they can structure their transactions in ways that take advantage of these standing rules. Among other things, if the investor is from a State that does not have a BIT with the

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State in which he wishes to invest, he may want to consider investing through a subsidiary in a third State that does have such a BIT. Because these considerations can be complex, investors and corporate counsel would be wise to consult with experienced outside counsel before making these decisions.

Universe of Protections Expanded By Most Favoured Nation Clauses

A common feature of many modern BITs is a most favoured nation treatment clause ("MFN Clause"). An MFN Clause requires State B to give investors from State A treatment that is at least as favourable as the treatment it extends to investors from any third State. In principle, this means that the investor from State A is entitled to rely, not only on the protections afforded by the BIT that State B has with State A, but on any of the superior protections that may be contained in BITs between State B and any other country. In other words, where it applies, the MFN Clause allows the investor from State A to pick and choose among the provisions contained in all of State B's investment agreements. As the number of investment agreements multiplies around the world, the MFN Clause is becoming an increasingly powerful tool that investors and corporate counsel should not overlook.

Precise Scope of MFN Clauses Unsettled. The precise wording and structure of MFN Clauses differ from investment agreement to investment agreement. As a result, MFN Clauses can vary in their meaning and scope.

Even with respect to similarly-worded MFN Clauses, the case law has produced divergent results. Among the more controversial issues is the extent to which MFN Clauses apply to procedural as well as substantive matters.

Some tribunals have tended to construe MFN Clauses generously for investors. In *Gas Natural SDG, S.A. v. The Argentine Republic*, (ICSID, Decision on Jurisdiction) (Case No. ARB/03/10) (June 17, 2005), for example, Gas Natural, a Spanish corporation, was part of a consortium that owned a 70 percent stake in a newly-privatised natural gas company in Argentina. Like the claimant in the *CMS* case described above, Gas Natural brought a BIT claim (in this case, under the Spain-Argentina BIT) alleging damages arising out of the draconian financial measures imposed in response to Argentina's economic crisis.

Argentina contested jurisdiction, arguing that Gas Natural failed to comply with the BIT's local courts provision, which, according to Argentina, required the claimant, first, to submit its dispute to the national courts, and then to wait for a period of at least 18 months before it could submit its dispute to ICSID arbitration. Gas Natural, in turn, argued that the MFN Clause excused it from any such requirement, noting that Argentina had numerous BITs with other States that did not require prior resort to national courts. Argentina insisted that the MFN Clause in the BIT at issue did not extend to procedural aspects of the investor-State dispute mechanism, but the Tribunal disagreed. It stated that: "Unless it appears clearly that the state parties to a BIT … settled on a different method for resolution of disputes than may arise, most-favored-nation provisions in BITs should be understood to be applicable to dispute settlement."(*Id.* at Para. 49). Thus, the Tribunal upheld jurisdiction over Gas Natural's claims. Other Tribunals have reached similar results. *See, e.g., Siemens A.G. v. The Argentine Republic* (ICSID, Decision on Jurisdiction) (Case No. ARB 02/8) (August 3, 2004) (MFN Clause in Germany-Argentina BIT allowed investor to bypass local courts requirement and 18-month waiting period, invoking Chile-Argentina BIT, which contained no such local courts requirement or waiting period); *Emilio Agustín Maffezini v. The Kingdom of Spain* (ICSID, Decision on Jurisdiction) (Case No. ARB/97/7) (January 25, 2000) (MFN Clause in Spain-Argentina BIT allowed investor to bypass local courts requirement and 18 month waiting period, in favour of the Spain-Chile BIT, which contained a more favourable 6-month waiting period and no local courts requirement).

On the other hand, some Tribunals have taken a cautious approach, construing MFN Clauses more narrowly than their plain language would suggest. In the *Maffezini v. Spain* case, for example, although the Tribunal held that dispute settlement provisions generally fall within the ambit of MFN Clauses, the Tribunal cautioned against allowing investors to use MFN Clauses to circumvent "very specific provisions [that] reflect the precise will of the contracting parties." (*Maffezini, supra*, at Para. 63). It admonished that: "As a matter of principle, the beneficiary of the [MFN] clause should not be able to override public policy considerations that the contracting parties might have envisaged as fundamental conditions for their acceptance of the agreement in question…" (*Id.* at Para. 62).

Indeed, several recent decisions have endorsed a presumption *against* extending MFN treatment to procedural matters. In *Plama Consortium Ltd. v. Bulgaria,* (ICSID, Decision on Jurisdiction) (Case No. ARB/03/24) (February 8, 2005) for example, the tribunal found that the investor could not rely on the MFN Clause in the Bulgaria-Cyprus BIT to take a dispute to ICSID arbitration, where the Bulgaria-Cyprus BIT reserved for the parties a specific and much more limited dispute resolution mechanism. It held that "an MFN provision in a basic treaty does not incorporate by reference dispute settlement provisions in whole or in part set forth in another treaty, unless the MFN provision in the basic treaty leaves no doubt that the Contracting Parties intended to incorporate them." *Id.* at Para. 223. Other decisions rejecting MFN arguments include *Salini Construttori S.p.A. and Italstrade S.p.A. v. The Hashemite Kingdom of Jordan* (ICSID, Decision on Jurisdiction) (Case No. ARB/02/13) (November 29, 2004) (MFN Clause in the Italy-Jordan BIT, which did not contain an Umbrella Clause, could not be used to import an Umbrella Clause from other investment agreements executed by Jordan); and *Tecnicas Medioambientales Tecmed S.A. v. The United Mexican States* (ICSID) (Case No. ARB (AF)/00/2) (May 29, 2003) (MFN Clause in Spain-Mexico BIT could not be used to invoke provision in Austria-Mexico BIT that allowed for retroactive application of the BIT to government acts that occurred before entry into force).

In sum, as with many issues in investor-State arbitration, the case law on MFN Clauses is in flux and continuously evolving. Investors and corporate counsel should examine the precise wording of the investment agreement in question and proceed with caution. But in every instance, they should at least explore whether there is an MFN argument that could improve their position.

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Fair and Equitable Treatment: A Powerful and Flexible Cause of Action

Fair and equitable treatment is becoming one of the most important, if not the most important, of the substantive obligations. Nearly every investor-State arbitration these days includes a fair and equitable claim. Recent years have witnessed a string of major awards for investors premised in whole or in part on a breach of this standard.

Fair and equitable treatment is an absolute standard of treatment to which foreign investors are entitled regardless of how a State treats its own nationals. In some sense, it is a "gap-filling" or "catch-all" provision that is designed to guarantee foreign investors an internationally-required level of protection, even when other more-specific standards are not implicated.

Tribunals have been reluctant to reduce fair and equitable treatment to a single legal standard or formula. "The standard is to some extent a flexible one which must be adapted to the circumstances of each case." (*Waste Management, Inc. v. United Mexican States*, (ICSID, Final Award) (Case No. ARB (AF)/00/3) (April 30, 2004) at Para. 99.) One tribunal attempted to summarise the fair and equitable jurisprudence that has evolved under NAFTA as follows:

"[T]he minimum standard of treatment of fair and equitable treatment is infringed by conduct attributable to the State and harmful to the claimant if the conduct

- is arbitrary, grossly unfair, unjust or idiosyncratic;
- is discriminatory and exposes the claimant to sectional or racial prejudice; or
- involves a lack of due process leading to an outcome which offends judicial propriety-as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process." *Id.* (bullets added).

The Parties to NAFTA have taken the position that the fair and equitable standard is bounded by customary international law. Some tribunals, however, have disagreed with this view. Most recently, for example, in *Saluka Investments BV v. The Czech Republic*, the tribunal held that "the 'fair and equitable treatment' standard … is an autonomous Treaty standard," unmoored by customary law, "and must be interpreted in light of the object and purpose of the Treaty … ." (*Saluka Investments BV (The Netherlands) v. The Czech Republic*, (UNCITRAL, Partial Award) (March 17, 2006) at Para. 309).

Construing the Netherlands-Czech Republic BIT, the tribunal in *Saluka* offered its own articulation of what fair and equitable treatment means:

"[W]ithout undermining its legitimate right to take measures for the protection of the public interest, … [the Contracting State has] assumed an obligation to treat a foreign investor's investment in a way that does not frustrate the investor's underlying legitimate and reasonable expectations. A foreign investor whose interests are protected under the Treaty is entitled to expect that the [Contracting State] will not act in a way that is

- manifestly inconsistent;
- non-transparent;
- unreasonable (i.e. unrelated to some rational policy); or
- discriminatory (i.e. based on unjustifiable distinctions)." *Id.* (bullets added).

The content of the fair and equitable standard is too complex to address in detail here. But recent jurisprudence offers three important lessons for investors and corporate counsel.

First, the fair and equitable treatment analysis may stress different elements in different circumstances, depending on the nature of the dispute. In a challenge to a judicial measure, for example, the central question may be due process. When an administrative proceeding is at issue, the key factor may be transparency. In other situations, the issue may be whether government officials acted in a fundamentally arbitrary fashion. The absence of a single uniform standard can make it difficult for investors and corporate counsel to determine whether they have a viable claim. On the other hand, the fair and equitable treatment standard provides enormous flexibility in ensuring protection for investors in a wide variety of circumstances.

Second, the fair and equitable treatment obligation may provide a remedy even where no expropriation has occurred. For example, in the *CMS* case discussed above, the tribunal rejected the expropriation claim because the complained of measures did not result in a "substantial deprivation of the fundamental rights of ownership nor have these rights been rendered useless." (*CMS Gas Transmission Co. v. The Argentine Republic (ICSID, Award) (Case No. ARB/01/08) (May 12, 2005)*, at Para. 259). As the tribunal explained further, however, the absence of a "substantial deprivation" is no obstacle to finding a violation of fair and equitable treatment. A central element of that obligation, the tribunal held, is the duty to maintain a stable and predictable legal and business framework on which foreign investors can rely. In finding a breach of that duty, it noted that the government had "entirely transform[ed] and alter[ed] the legal and business environment under which [CMS'] investment was decided and made." *Id.* at Para. 275. Notably, it reached this conclusion without regard to whether there was "any deliberate intention and bad faith in adopting the measures in question," explaining that "such intention and bad faith … are not an essential element of the standard." *Id.* at Para. 280.

Third, as *CMS* and other cases illustrate, one of the most significant principles emerging from recent jurisprudence is the sharpened focus on the investor's "legitimate and reasonable expectations" at the time of the investment, and whether those expectations have been frustrated unreasonably by actions attributable to the State. (*Saluka, supra*, at Para. 302.) As one tribunal explained, for example, fair and equitable treatment includes the obligation not to "affect the basic expectations that were taken into account by the foreign investor to make the investment." (*Tecmed, supra*, at Para. 154). In light of this trend in the case law -- although by no means a necessary element of a fair and equitable treatment claim -- investors and corporate counsel may be well advised to document any government representations on which they reasonably relied in making their investment decision.

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Conclusion

Investment treaty arbitration is an increasingly important tool in the arsenal of international business. As the number of treaties and investment claims continues to grow, investors and corporate counsel are well advised to stay abreast of developments in this area and to keep this mechanism in mind as they structure transactions, anticipate potential disputes with government entities, and attempt to resolve such disputes when they arise.

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Wilmer Cutler Pickering Hale and Dorr LLP is an international law firm with offices in Washington, D.C., New York, London, Baltimore, Beijing, Berlin, Boston, Brussels, Munich, Northern Virginia, Oxford, Palo Alto and Waltham. The firm offers one of the world's premier international arbitration and dispute resolution practices, covering virtually all forms of international arbitration and dispute resolution. The firm is experienced in handling disputes administered under a wide variety of institutional rules, including the ICC, AAA, LCIA, UNCITRAL, and ICSID rules.

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