Chapter 2

Recent Developments in Investment Treaty Jurisprudence: Arbitrating Contract Claims Under Umbrella Clauses

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Introduction

International investment agreements, ranging from bilateral investment treaties ("BITs") to multilateral agreements such as the Energy Charter Treaty, the Central American Free Trade Agreement ("CAFTA"), and the 1987 ASEAN investment agreement, provide foreign investors with an important mechanism for resolving disputes with sovereigns. Among other things, investment agreements require host governments to guarantee foreign investors and their investments treatment in accordance with international law standards. These standards are intended to help protect foreign investors and their investments against, *inter alia*, discriminatory measures, uncompensated expropriations of property, and denials of due process or fair and equitable treatment. Investment agreements typically allow foreign investors to enforce their treaty rights through international arbitration -- known as "investor-State arbitration" -- thus providing foreign investors with a neutral forum for resolving such disputes. The investment agreement will typically specify one or more arbitral institutions, such as the International Centre for the Settlement of Investment Disputes ("ICSID"), or ad hoc arbitration (often pursuant to the UNCITRAL Rules, which are widely-used arbitration procedural rules devised by the United Nations Commission on International Trade Law), that will establish the basic procedures for the arbitration.

In addition to affording foreign investors protection under international law standards, many investment agreements also provide a right, through "umbrella clauses," for foreign investors to arbitrate contract disputes with sovereigns. Although umbrella clauses take many forms, they typically require each State party to observe any obligation arising from particular commitments it has entered into with regard to investments. Under the broad interpretation of these clauses adopted by some arbitral tribunals, a sovereign's breach of contract with a foreign investor or investment becomes, by virtue of the umbrella clause, a breach of treaty actionable through investor-State arbitration.

The precise scope and meaning of these umbrella clauses, however, can vary, and they have been interpreted differently by different arbitral tribunals. This article reviews recent developments in tribunal decisions and highlights the differences in their approaches. These issues merit close attention from companies doing international business and their lawyers as they structure foreign investments, particularly when they negotiate with instrumentalities of foreign States. In the right circumstances, umbrella clauses in investment agreements can play an important role in securing the value of foreign investments.

The Debate over the Scope of Umbrella Clauses

Umbrella clauses emerged in the late 1950s in West German and British model investment treaties in reaction to various events, including, among other things, the Anglo-Iranian Oil Company's concession dispute with Iran following Iran's revocation of a pipeline concession, the Suez Canal nationalisation, and post-war West German concession disputes with East European states. The first example of such a clause appears to have been in the West Germany-Pakistan BIT of 1959, Pakistan's first BIT, which provided:

"Either party shall observe any other obligation it may have entered into with regard to investments by nationals or companies of the other party."

Such clauses thus emerged as an additional layer of international protection for foreign investment contracts. *See* Thomas W. Wälde, "The 'Umbrella' (or Sanctity of Contract/Pacta sunt Servanda) Clause in Investment Arbitration: A Comment on Original Intentions and Recent Cases," 1 Transnat'l Dispute Management 31 & n.71, 33 (October 2004).

From 1959 onwards, umbrella clauses of various forms and types began to appear in numerous investment treaties. *See, e.g.*, "Interpretation of the Umbrella Clause in Investment Agreements," OECD Working Papers on International Investment, No. 2006/3 (October 2006). These clauses, however, did not receive in-depth analysis until a pair of cases in 2003-2004 came to starkly different conclusions on whether and to what extent such clauses could form the basis for a treaty claim based on breach of contract. These cases, *SGS v. Pakistan*, Decision on Jurisdiction, ICSID Case No. ARB/01/13 (6 August 2003) and *SGS v. Philippines*, Decision on Jurisdiction, ICSID Case No. ARB/02/6 (29 January 2004), involved contracts between SGS, a Swiss company, and the governments of Pakistan and the Philippines, respectively, for pre-shipment inspection services of imported goods. In *SGS v. Pakistan*, SGS filed a request for arbitration with ICSID pursuant to the Switzerland-Pakistan BIT after the government terminated its services contract with SGS. SGS's arbitration request included both treaty-based claims and contract-based claims. SGS's contract-based claims relied, *inter alia*, on the BIT's umbrella clause, Article 11, which stated: "Either Contracting Party shall constantly guarantee the observance of the commitments it has entered into with respect to the investments of the investors of the other Contracting Party." In a partial award on jurisdiction, the ICSID tribunal ruled that it had jurisdiction over SGS's treaty claims, but not its contract claims. Specifically, the tribunal held that "Article 11 of the BIT would have to be considerably more

specifically worded before it can reasonably be read in the extraordinarily expansive manner submitted by [SGS]," namely, that "all breaches of each State's contracts with investors of the other State are forthwith converted into and to be treated as breaches of the BIT." (*SGS v. Pakistan*, at paras. 171, 173). The tribunal reserved the possibility that "a violation of certain provisions of a State contract" could constitute a violation of an umbrella clause "under exceptional circumstances." (*Id*. at para. 172).

In *SGS v. Philippines*, SGS filed a request for arbitration with ICSID pursuant to the Switzerland-Philippines BIT after a payment dispute arose between SGS and the government. This request also included both treaty-based and contract-based claims. SGS's contract-based claims relied, *inter alia*, on the BIT's umbrella clause, which stated in Article X(2) that: "Each Contracting Party shall observe any obligation it has assumed with regard to specific investments in its territory by investors of the other Contracting Party." In contrast to the tribunal's decision in the *SGS v. Pakistan* case, the tribunal in the *Philippines* case ruled that it had jurisdiction over both SGS's treaty claims and its contract claims. Specifically, the tribunal held that "Article X(2) makes it a breach of the BIT for the host State to fail to observe binding commitments, including contractual commitments, which it has assumed with regard to specific investments." (*SGS v. Philippines*, at para. 128). The tribunal also observed that the analysis of the tribunal in *SGS v. Pakistan* was not only "unconvincing," but that it "failed to give any clear meaning to the 'umbrella clause.'" (*Id*. at para. 125).

These two decisions, which came within months of each other, reflect materially different approaches to the interpretation of umbrella clauses. In the wake of these decisions, there has been a substantial amount of commentary, but no uniformity of approach, and more recent decisions by other tribunals continue to reflect different approaches to interpreting the scope of these clauses.

Recent Developments in Tribunal Jurisprudence

Tribunals in more recent cases have reached different results as to how to interpret umbrella clauses. A hypothetical example will help to illustrate how these more recent decisions have approached this issue.

Let's say Company A from State Alpha wins a concession to build and operate an energy production and distribution system in State Beta. The concession agreement is between Company A and State Beta. Company A begins to establish the infrastructure, pouring significant resources into the construction and maintenance of the project in State Beta. Subsequently, the Administration of State Beta changes and new government regulators launch an arbitrary and politically-motivated investigation into Company A's compliance with regulatory requirements, causing State Beta to withhold concession contract payments owed to Company A. Company A does not believe that the local courts in State Beta provide an advantageous forum for settling this dispute -- it believes they are slow and susceptible to political influence. There is a BIT between State Alpha and State Beta, which provides for investor-State arbitration. Counsel for Company A knows that it could try to bring claims for expropriation or denial of fair and equitable treatment using provisions in the BIT, but a breach of these international law standards may be difficult to prove under the facts. The BIT also contains a broadly-worded umbrella clause like those found in a number of BITs: "Each Party shall observe any obligation it may have entered into with regard to investments."

Can Company A submit a breach of contract claim to BIT arbitration, without proving a violation of international law standards?

In answering this question a tribunal may consider whether the concession agreement between Company A and State Beta is the kind of contract -- and whether Company A's dispute is the kind of contractual dispute -- that the umbrella clause in question was designed to address.

Is the concession contract covered by the umbrella clause?

The plain language of the umbrella clause above would suggest the answer is, "yes." The clause requires the contracting State to observe "*any* obligation" it has entered into with respect to "investments." The text does not admit of any exceptions to its broad scope, and State Beta would be hard-pressed to characterise Company A's substantial capital expenditure to construct an energy grid as anything other than an "investment."

A number of recent decisions have found that all contracts are covered by umbrella clause language similar to that described above, following the analysis of the tribunal in *SGS v. Philippines*. For example, in *Eureko B.V. v. Poland*, Partial Award, Ad Hoc Arbitration (19 August 2005), the tribunal interpreted the Netherlands-Poland BIT's umbrella clause, which states that "Each Contracting Party shall observe any obligations it may have entered into with regard to investments of investors of the other Contracting Party." The *Eureko* tribunal expressly concurred with the *SGS v. Philippines* tribunal's holding that the umbrella clause "means what it says." (*Eureko* at para. 256).

Other decisions have reached similar results. For example, in *Siemens A.G. v. Argentina*, Award, ICSID Case No. ARB/02/8 (6 February 2007), involving the Germany-Argentina BIT, the tribunal held that the umbrella clause "has the meaning that its terms express, namely, that failure to meet obligations undertaken by one of the Treaty parties in respect to any particular investment is converted by this clause into a breach of the Treaty." (*Id*. at para. 204). The tribunal went on to state that it "does not subscribe to the view … that investment agreements should be distinguished from concession agreements of an administrative nature, … [because] the term 'investment' … linked as it is to 'any obligations,' would cover any binding commitment entered into by Argentina in respect of such investment." (*Id*. at para. 206). *See also LG&E Energy Corp. v. Argentina*, Decision on Liability, ICSID Case No. ARB/02/01, para. 170 (3 October 2006) (noting that an umbrella clause "creates a requirement for the host State to meet its obligations towards foreign investors, including those that derive from a contract"); *Sempra Energy Int'l v. Argentina*, Decision on Objections to Jurisdiction, ICSID Case No. ARB/02/16, para. 101 (11 May 2005) ("the specific guarantee of a general 'umbrella clause' . . . involv[es] the obligation to observe contractual commitments concerning the investment"); *cf. Enron Corp. v. Argentina*, Award, ICSID Case No. ARB/01/3, paras. 273-74 (22 May 2007) (observing that "[u]nder its ordinary meaning the phrase 'any obligation' refers to obligations regardless of their nature," but noting that "'[o]bligations' covered by the 'umbrella clause' are nevertheless limited by their object: 'with regard to investments'"); *Noble Ventures, Inc. v. Romania*, Award, ICSID Case No. ARB/01/11, para. 61 (12 October 2005) (holding that the text of the U.S.-Romania BIT's umbrella clause indicates that "the Parties had as their aim to equate contractual obligations governed by municipal law to international treaty obligations as established in the BIT," but reserving question whether "the expression 'any obligation,' despite its apparent breadth, must be understood to be subject to some limitation in the light of the nature and object of the BIT").

Other recent decisions, however, have taken a different tack, indicating that only certain kinds of public contracts are covered by umbrella clauses. In particular, in *El Paso Energy Int'l Co. v.*

Argentina, Decision on Jurisdiction, ICSID Case No. ARB/03/15 (27 April 2006) and *Pan American Energy LLC v. Argentina*, Decision on Preliminary Objections, ICSID Case No. ARB/03/13 (27 July 2006), two different tribunals (although consisting of the same presiding arbitrator and the same state-appointed co-arbitrator) interpreted the umbrella clause in the U.S.-Argentina BIT as *not* extending "[t]reaty protection to breaches of an ordinary commercial contract entered into by the State or a State-owned entity," but only to special "investment protections contractually agreed by the State as a sovereign -- such as a stabilization clause -- inserted in an investment agreement." (*El Paso* at para. 81; *see also Pan American* at para. 109). Ultimately, the tribunals held that "an umbrella clause cannot transform any contract claim into a treaty claim, as this would necessarily imply that any commitments of the State in respect to investments, even the most minor ones, would be transformed into treaty claims." (*El Paso* at para. 82; *see also Pan American* at para. 110.). As a result, the tribunals drew a distinction between contracts with the "State as a merchant" and the "State as a sovereign." (*El Paso* at para. 79; *see also Pan American* at para. 108).

In our hypothetical case, the energy concession agreement between Company A and State Beta could well be covered even under the more limited interpretations suggested by *El Paso* and *Pan American*, based on the notion that a public concession is not an ordinary commercial contract, but involves a granting of rights by the government acting in a sovereign, rather than a purely proprietary, capacity. Nevertheless, the ongoing differences in approach among arbitral tribunals create some measure of uncertainty as to how these clauses will be interpreted.

Is this kind of contract dispute covered by the umbrella clause?

A second area of concern for some tribunals has been whether the umbrella clause in question extends to all or only some forms of contract disputes.

The umbrella clause in our hypothetical case provides that each State "*shall observe* any obligation" it has entered into with respect to investments, implying that *any* breach of such an obligation would create an actionable claim under the BIT. Most tribunals that have confronted this issue have resolved it in favor of this broad reading. *See, e.g.*, *Eureko* at para. 246 (observing that the "plain meaning" of the phrase "shall observe" in the umbrella clause is "imperative and categorical"); *SGS v. Philippines* at para. 115 (emphasising the umbrella clause's use of the "mandatory term 'shall'" in finding that even a simple failure to pay what is allegedly owed under a contract would be incorporated into the treaty's umbrella clause); *cf. Noble Ventures* at paras. 56, 60, 61 (holding that the U.S.-Romania BIT's umbrella clause "clearly falls into the category of the most general and direct formulations tending to an assimilation of contractual obligations to treaty ones" based in part on its use of the term "shall observe," but reserving question whether the umbrella clause "perfectly assimilates to breach of the BIT any breach by the host State of any contractual obligation as determined by its municipal law").

Nevertheless, some tribunals have suggested that only certain kinds of breaches come within the scope of the umbrella clause. For example, in *Joy Mining Machinery Ltd. v. Egypt*, Award, ICSID Case No. ARB/03/11 (6 August 2004), the tribunal construed a typical umbrella clause in Article 2(2) of the UK-Egypt BIT. The Claimant and a government mining organisation had entered into a contract for a British company to provide mining services and supporting equipment for a mining project. Disputes over performance ensued, including over certain bank guarantees. The tribunal determined that because a bank guarantee is clearly a commercial element of the contract, this was a contractual dispute that should be resolved exclusively pursuant to the contract's dispute resolution clause: "it could not be held that an umbrella clause inserted in the Treaty, and not very prominently, could have the effect of transforming all contract disputes into investment disputes under the Treaty, unless of course there would be a clear violation of the Treaty rights and obligations or a violation of contract rights of such a magnitude as to trigger the Treaty protection . . . ." (*Id.* at para. 81). The tribunal then observed, however, that the Claimant had not "credibly alleged that there was Egyptian State interference with the Company's contract rights," suggesting that an umbrella clause claim might have been available if such interference had taken place. (*Id.* at para. 82).

Similarly, in *CMS Gas Transmission Co. v. Argentina*, Award, ICSID Case No. ARB/01/8 (25 April 2005), the tribunal stated that "not all contract breaches result in breaches of the Treaty. The standard of protection of the Treaty will be engaged only when there is a specific breach of treaty rights and obligations or a violation of contract rights protected under the treaty. Purely commercial aspects of a contract might not be protected by the treaty in some situations, but the protection is likely to be available when there is significant interference by governments or public agencies with the rights of the investor." (*Id.* at para. 299).

Similar to *El Paso* and *Pan American*, the tribunals in *Joy Mining* and *CMS* suggest that a line should be drawn between ordinary commercial contractual disputes, where one party happens to be a government entity, and other kinds of governmental interference with contract rights. Where exactly they would draw that line is unclear. Turning back to our hypothetical case, a tribunal inclined to follow the approach of *Eureko* and *SGS v. Philippines* -- giving full effect to the language of a broadly-worded umbrella clause -- would likely allow Company A to submit its breach of contract claim to investor-State arbitration. If, on the other hand, the tribunal were to follow the more limited interpretations suggested by *Joy Mining* and *CMS*, Company A might have a more difficult time. It could argue that State Beta's politically-motivated actions constitute the kind of state interference with contract rights that ought to be cognizable under an umbrella clause; but if Company A is effectively required to make a showing equivalent to expropriation or denial of fair and equitable treatment, the umbrella clause would provide Company A little added protection.

Standing: What if the concession agreement were between State Beta and a locally incorporated subsidiary established by Company A to operate the concession in State Beta? Could Company A still bring a contract claim under the umbrella clause?

Another important issue is whether the investor must itself be a party to the contract in question in order to have standing to invoke the umbrella clause. This is particularly important because many foreign investors do business through locally incorporated subsidiaries or affiliates. In our hypothetical case, the umbrella clause states that: "Each Party shall observe any obligation it may have entered into with regard to investments." It does not specify *to whom* the contractual obligation must be owed. That is, the plain language of the clause does not appear to be limited to contractual obligations owed by the Party to the foreign investor (*i.e.*, to Company A); rather, the plain language suggests that it also covers contractual obligations owed to investments of the investor (*i.e.*, in this case, to Company A's wholly-owned subsidiary). On this interpretation, Company A could bring an umbrella clause claim against State Beta for breach of the concession agreement between the State and the locally-incorporated subsidiary. *See, e.g.*, *Enron Corp. v. Argentina*, Decision on Jurisdiction (Ancillary Claim), ICSID Case No. ARB/01/3, paras. 32, 46, 52 (2 August 2004).

Nonetheless, at least one tribunal construing a similar umbrella clause has held that the foreign investor must be the contracting party in order to bring a contract claim pursuant to an umbrella clause. In *Siemens*, the tribunal held that "to the extent that the obligations assumed by the

State party are of a contractual nature, such obligations must originate in a contract between the State party to the Treaty and the foreign investor as, for instance, in the *SGS* cases." (*Siemens* at para. 205). *See also Azurix Corp. v. Argentina*, Award, ICSID Case No. ARB/01/12, para. 384 (14 July 2006). Similar issues can also arise where the aggrieved party is part of a joint venture. *See, e.g., Impregilo S.p.A. v. Pakistan*, Decision on Jurisdiction, ICSID Case No. ARB/03/3 (22 April 2005).

Exhaustion of remedies: What if the concession agreement contains its own arbitration clause? Must contract remedies be exhausted as a prerequisite for bringing an umbrella clause claim?

The existence of alternative procedures for pursuing contract claims may also create hurdles to submitting a contract dispute to treaty arbitration. Tribunals have considered cases where States have resisted treaty arbitration of contract claims on the ground that the contract in dispute contains its own dispute resolution clause requiring, for example, arbitration under particular rules or procedures. The majority of these tribunals have held that the existence of a contract remedy does not affect the jurisdiction of a BIT tribunal, making BIT arbitration available even where the contract contains its own dispute resolution requirements. In addition, they have held there is no need to exhaust alternative contract remedies before bringing a BIT arbitration. (*See, e.g., Noble Ventures* at para. 53).

There is a minority view, however, exemplified by *SGS v. Philippines*, which held that a contract claim cannot be pursued under an umbrella clause unless the investor, for good reason, was unable to avail itself of the exclusive domestic remedies provided for in the contract: "Thus the question is not whether the Tribunal has jurisdiction . . . . The question is whether a party should be allowed to rely on a contract as the basis of its claim when the contract itself refers that claim exclusively to another forum. In the Tribunal's view the answer is that it should not be allowed to do so, unless there are good reasons, such as *force majeure*, preventing the claimant from complying with its contract." (*SGS v. Philippines*, at para. 154).

Towards a Text-Based Approach?

As the cases discussed above illustrate, some tribunals have been willing to go beyond the plain text of the umbrella clauses in question to achieve certain policy results. Thus, for example, the *SGS v. Pakistan* tribunal acknowledged that "[a]s a matter of textuality . . . the scope [of the umbrella clause] . . . appears susceptible of almost indefinite expansion," yet went on to surmise that the plain meaning could not have been what the parties intended. (*SGS v. Pakistan*, at paras. 166, 171).

The differing approaches taken in recent cases means some continued uncertainty regarding whether, and to what extent, contracts will receive protection under a BIT. This uncertainty can be costly and can act as a disincentive for investments. Tribunals could reduce this uncertainty by adopting a text-based approach to interpretation, in which, as one tribunal put it, the umbrella clause "means what it says." (*Eureko* at para. 256). This approach would better recognise that "there are differences between the wording of [one] clause and the clauses in the other cases," and thus that terms should be given their "ordinary meaning." (*Noble Ventures* at para. 50).

When States negotiating BITs wish to eliminate or limit the scope of umbrella clauses, they know how to do so. For example, many U.S. BITs from the 1980s and 1990s contained broad and unrestricted umbrella clause language, such as that discussed in our hypothetical. *See, e.g.*, Article II(2)(c), U.S.-Argentina BIT ("Each Party shall observe any obligation it may have entered into with regard to investments."). By contrast, the 2004 U.S. Model BIT replaced the standard umbrella clause with a detailed definition of the types of contracts for which breach of contract claims may be submitted to arbitration. *See* 2004 U.S. Model BIT, Article 1 (covered contracts include those involving natural resources, the supply of utilities services such as water or electricity, or the undertaking of civic infrastructure projects). A text-based approach, which recognises that government negotiators pay careful attention to the precise wording used in international investment agreements, would serve to increase certainty and predictability for investors and governments alike.

Conclusion

As recent tribunal awards illustrate, there is continuing disagreement among some tribunals as to the precise scope and meaning of umbrella clauses. Although some of this uncertainty may be due to differences among arbitrators, it also is the result of nuances in the text of each treaty, which underscores the importance of reading the text very closely when evaluating the strength of a potential contract-based treaty arbitration. The umbrella clause can potentially be a powerful tool for foreign investors in the event of a contractual dispute with a host state. It is essential, however, for investors and corporate counsel to stay abreast of continuing developments in the jurisprudence and to seek expert guidance where appropriate.

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