

# Dispute Resolution Hotline

June 21, 2013

## INVESTORS' RIGHT OF 'FAIR AND EQUITABLE TREATMENT' UNDER BILATERAL INVESTMENT TREATY UPHELD BY ICSID

Stamping on the strength of Bilateral Investment Treaties ("BITs") the International Centre for Settlement of Investment Disputes ("ICSID") has recently passed awards on two elongated disputes which are of significance, namely, Inmaris Perestroika Sailing Maritime Services GmbH and others v. Ukraine<sup>1</sup> ("Inmaris") and The Rompetrol Group N.V. v. Romania<sup>2</sup> ("Rompetrol"). The awards have explored the dimensions of investor rights under the BITs vis-a-vis the standard of 'fair and equitable treatment'. The awards have added to the growing body of investment arbitration awards which give a liberal interpretation to the 'fair and equitable treatment' standard under BITs.<sup>3</sup>

In the Inmaris case, the blatant abrogation of contractual obligations by the State has been held to be a breach of the principle of 'fair and equitable treatment' as also an act of expropriation. In the Rompetrol case, the tribunal pronounced that State acts such as criminal investigations could also be considered breach of BIT obligation of 'fair and equitable treatment' if not carried out in a just manner. It was further laid down in this case that multiple acts by the State, considered cumulatively, could lead to breach of treaty obligations even though the same acts may not be violative of the Netherlands-Romania BIT when considered individually.

### INMARIS CASE

#### Factual Background

A series of contracts ("Contracts") were entered into by Inmaris Perestroika Sailing Maritime Services GmbH ("Claimant"), of Germany, with a Ukrainian state-owned education institution ("Institute"). The Contracts recorded that the Institute would use 'the Khersones', a windjammer sail training ship owned by the Institute, to train cadets for the Ukraine national fishery fleet. The Contracts also allowed the Claimant to use the ship to market sailing tours and other onboard events. The Claimant had further agreed to secure finance for reconstruction of the Khersones. The sailing tours and events were devised as a means of recovering the monies invested. Hence, the activities and the investment of the Claimant as regards the Khersones accorded them a safeguard under the Germany-Ukraine BIT.

Disputes between the parties arose when the Ukrainian Ministry of Agricultural Policy, in April 2006, instructed that the Khersones was not allowed to leave the territorial waters of Ukraine. The Ukrainian Ministry conveyed similar instructions to the port authorities and border guards to ensure compliance with the ban. This ban ensued for one year and due to the same the Claimant had to cancel a planned summer sailing schedule of the Khersones which resulted in considerable losses to the Claimant and two other Claimant companies went into insolvency. Aggrieved by this act of the Ukrainian government ("Respondent"), Claimants invoked arbitration under the Germany-Ukraine BIT.

#### Arguments by the Parties

The Claimant contended that the impugned ban on the movement of the Khersones was a breach of the right of the Claimant to 'fair and equitable treatment' under Article 2(1) of the Germany-Ukraine BIT.<sup>4</sup> It further contended that the acts of the Respondent amounted to expropriation and the Claimant was entitled to compensation for the same.

The Respondent, on the other hand contended that the acts of the Respondent were not a breach of the 'fair and equitable treatment' standard under the Germany-Ukraine BIT. The Respondent urged the arbitral tribunal ("Tribunal") to interpret the term 'fair and equitable treatment' in accordance with the international minimum standard of treatment required by customary international law, i.e., only gross unfairness or actions that shocks one's sense of legal propriety could be considered unfair and inequitable. Further, it was submitted that the Respondent did not breach the standard as the ban imposed by the Respondent on the Khersones did not satisfy the high threshold of gross unfairness shocking one's sense of legal propriety.

#### Award

The Tribunal considered the question whether the impugned ban on the Khersones was (a) a denial of fair and equitable treatment under the Germany-Ukraine BIT, (b) arbitrary and (c) an invalid expropriation of the Claimants' investment. The Tribunal answered the question in the positive on all counts and held that the Respondent was in breach of its Germany-Ukraine BIT obligations.

a) Fair and equitable treatment under the Germany-Ukraine BIT

As regards the interpretation of 'fair and equitable treatment' under Article 2(1) of the Germany-Ukraine BIT, the Tribunal, disagreeing with the restricted interpretation of the 'fair and equitable treatment' standard proposed by the Respondent, stated that a government act could be unfair or inequitable if it is in breach of specific commitments, if

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they are undertaken for political reasons or other improper motives, if the investor is not treated in an objective, even-handed, unbiased and transparent way, or for any other reason.

b) The arbitrary nature of the ban on the 'Khersones'

Addressing the issue of arbitrariness, the Tribunal held that the impugned ban was arbitrary since the same had no basis in the Contract and the Respondent failed to follow the due process in seeking reformation of the Contract, instead choosing to exercise its sovereign powers unilaterally.

c) Expropriation of the Claimants' investment

As regards the issue of expropriation under Art. 4(2) of the Germany-Ukraine BIT<sup>5</sup>, the Tribunal pronounced that the ban imposed on the movement of the Khersones, at a minimum, amounted to indirect expropriation as it permanently destroyed the value of Claimant's contractual rights and was not accompanied by any compensation. The Tribunal further stated that where a measure had been found expropriatory, the State must necessarily compensate even if the expropriation was for a public purpose. Since the Respondent, in this case, had not even compensated the Claimant for the expropriation, such expropriation was impermissible under the Germany-Ukraine BIT.

Therefore, the Tribunal decided the merits of the case in favour of the Claimant. It further observed that the Claimant had lost substantial profits, which it had been making from the venture in the previous years, and two of the Claimant companies had also undergone insolvency. In light of the same, the Tribunal awarded damages to Claimants for lost profits, unpaid loan amounts, frustrated expenses and insolvency costs.

## Analysis

The award makes it amply clear that where an investment is made by an investor of one State into another State, the other State cannot unilaterally rescind its contractual obligations under the garb of sovereign authority. The investor must be treated impartially and objectively so as to ensure compliance with the standard of fair and equitable treatment. The Tribunal has not limited the ambit of a breach of the standard to only gross unfairness but also has included politically motivated, subjective, biased or discriminatory acts. This adds to the growing jurisprudence for according adequate protection to the investors against the high-handedness of States in which the investments are made.

Further, it is observed that the Tribunal has added to the concept of indirect expropriation by holding that deprivation of the use of an investment even where the title in the asset is that of the investor State, as in the case of the Khersones, can also constitute indirect expropriation if the same is done by unilateral abrogation of the contract relating to investment on the part of the investor State.

## ROMPETROL CASE

### Factual Background

The dispute in this case arose out of investigations which were commenced by the National Anti-Corruption Office of Romania in May, 2004 relating to the privatization of Rompetrol Rafinare S.A. ("RRSA"), shortly after the controlling stakes of RRSA were sold to the Rompetrol Group N.V. ("**Claimant**") from the Netherlands.

### Arguments by the Parties

The Claimant asserted that the impugned investigations along with, *inter alia*, acts of attachment of shares of RRSA, detention of RRSA officials and press releases regarding the investigation were oppressive and in breach of the standard of 'fair and equitable treatment' to which Claimant's investment was entitled under Clause 3(1) the Netherlands-Romania BIT<sup>6</sup>. The Claimant contended that the 'fair and equitable treatment' standard contained the sub-elements of (a) transparency and the protection of the investor's basic expectations, (b) freedom from harassment, (c) procedural propriety and due process, and (d) good faith. The Claimant contended that the investigations carried on by Romania ("**Respondent**") in consonance with the other aforementioned acts of the Respondent constituted a breach of the sub-elements of the 'fair and equitable treatment' standard.

On the other hand, Romania maintained that the investigations and other proceedings undertaken by them were merely a part of its vital fight against corruption and were undertaken specifically within the framework of the stringent requirements placed upon the Respondent State by the European Union in the context of its application for EU membership. It further stated that there existed credible evidence regarding, *inter alia*, suspected wrongdoing in relation to the privatization of RRSA, suspected tax evasion by RRSA and suspected market manipulation in relation to the sale of RRSA shares on the Bucharest Stock Exchange. It was also submitted by the Respondent that there was no evidential basis for the allegations of bad faith or ulterior motive, made by the Claimant against the Respondent's prosecutorial authorities. It was contended that the claims brought by the Claimant against the Respondent at the arbitral tribunal ("**Arbitral Tribunal**") were with the intention of pressurizing the Respondent to discontinue the investigations and criminal proceedings against the Claimant.

### Award

The Arbitral Tribunal interpreted the standard of 'fair and equitable treatment' by measuring it against two essential elements under the Netherlands-Romania BIT. First element being the way in which the foreign investor or the foreign investment has been treated by the organs of the host State measured against the second element of expectations legitimately entertained by the foreign investor in making its investment.

The Arbitral Tribunal held that the Claimant, as part of its legitimate expectation, was entitled to expect that if its interests were caught up in the criminal process, directly or indirectly, the Respondent would take pro-active steps, to avoid or mitigate any unnecessary adverse effect on those interests without forsaking its sovereign right to enforce its criminal law. However, it was held that the actions of the Respondent fell short of the legitimate expectations of the Claimant. This was because they were excessive and amounted to harassment which was beyond the four corners of the criminal process.

The Arbitral Tribunal observed that multiple acts had been committed by the Respondent which cumulatively resulted in a violation of the fair and equitable treatment standard under the Netherlands-Romania BIT.

Thus, the Arbitral Tribunal has given a liberal interpretation to the 'fair and equitable treatment' standard of the Netherlands-Romania BIT and has held that the threshold for breach of the same was not limited to the host State's treatment of the investment as a whole. The threshold would also encompass specific individual acts, attributable to the State, taken together, if they were of sufficient seriousness to meet the standard, as in the present case.

The Arbitral Tribunal, further held, that both direct and indirect acts of the State could be in breach of the 'fair and equitable treatment' standard under the Netherlands-Romania BIT. Indirect acts would include action against the investor's executives for their activity on behalf of the investor as also action against the executives personally but with the intent to harm the investor. In this light, Respondent's acts of arresting the RRSA officials and the interception of telephone conversations of RRSA and its officials could be considered indirect acts which breached the fair and equitable standard. This element of the award has far reaching impact since it looks at the treatment of personnel of the investor, in their personal capacity, in measuring the breach of a Netherlands-Romania BIT standard.

The Arbitral Tribunal, however, refused to grant any damages to the Claimant despite agreeing that there had been a breach of the standard of 'fair and equitable treatment' and that legitimate expectations of the Claimant had not been fulfilled. The refusal was on the ground that the Claimant had failed to establish a link between the claimed illegality on the part of the host State and asserted loss suffered by the Claimant. Moreover, no comparison was drawn by the Claimant between the status quo ante and the Claimant's situation at the time that suit was brought.

## Analysis

The special character of this case is the fact that the investor's claims originate in and focus on measures taken by authorities of the host State in the area of investigation and possible prosecution of criminal offences. Moreover, these measures have been directed neither against the investor, nor even for the most part, against its investments in the host State, but rather against the executives of the investors in their official as well as personal capacity.

In this case, the Arbitral Tribunal has tried to walk the tightrope of balance between the sovereign right of a State to enforce its domestic law and the obligation of a State to comply with its international commitments. The Tribunal has clarified that mere action against an investor under the local criminal laws of a State cannot be considered to be a breach of a State's BIT obligations. The Tribunal was further disinclined to regard any breach or series of breaches of procedural safeguards provided by national or international law in the context of criminal investigations or prosecution as giving rise to a breach of an obligation of 'fair and equitable treatment'. However, it was held, that action by a host State under the garb of criminal investigation (beyond what was permissible within the domestic criminal statute) may collectively be considered a violation of an investor's right to 'fair and equitable treatment' depending on the nature and strength of the evidence in a particular case, on the impact of the events complained about on the protected investor or investment, and on the severity and persistence of any breaches that can be duly proved, as well as on whatever justification the host State may offer for the course of events.

The award passed by the Arbitral Tribunal is unusual in so far as the Arbitral Tribunal has cast upon the investor State an active duty to avoid / mitigate any adverse effect of enforcement of its local criminal laws on the investors, including the Claimant, under the Netherlands-Romania BIT. While this decision may be welcomed by investors for the increased amount of protection it provides to them from arbitrary State actions in terms of unwarranted criminal investigations and prosecutions, it rings an alarm bell for the host State to be extra cautious in their criminal proceedings against foreign investors. One would be reminded of the White Industries award<sup>7</sup> against India where excessive delay in enforcing an arbitral award led to damages against the government.

Increasingly, tribunals in BIT disputes are penalizing parties for the recalcitrant approach of state enforcement or judicial authorities. This broadens the ambit of State action since in a case like this one, it is not just the direct result of a criminal enforcement action but other allied excessive measures as well incidental to the enforcement action that are taken into account.

## CONCLUSION

The 'fair and equitable treatment' standard has been an important threshold for testing breach of BIT obligations. Where initially the standard was interpreted as an expression of the minimum standard of treatment (as contended by the Respondent in the Inmaris case), in the recent times the investment arbitration tribunals<sup>8</sup> have interpreted the standard more liberally to include legitimate expectations, manifest arbitrariness, denial of justice and due process, discrimination and abusive treatment.

In light of this fact, the awards in the Rompetrol and Inmaris cases spell further good news for foreign investors. The liberal interpretations given to the standard of 'fair and equitable treatment' under the BITs may give courage to the foreign investors to invest in other States without being inhibited by the anticipated actions of the State in which the investments are made. Where on the one hand, in the Inmaris case the Tribunal has held that the standard of 'fair and equitable treatment' would be violated if a State chooses to abrogate a contract with a foreign investor without following the prescribed due process. On the other hand, the Rompetrol Arbitral Tribunal has held that even processes under the criminal law of a State can be called into question if they are oppressive and discriminatory against the investor.

The wide application of the 'fair and equitable treatment' obligation has revealed its protective value for foreign investors but has also exposed a number of uncertainties and risks. A number of arbitral awards display a risk that tribunal may evaluate the 'fair and equitable' treatment standard only in terms of an investor's expectations, without due consideration given to a State's wider political and social obligations<sup>9</sup>. These uncertainties are mainly regarding the ambit of the 'fair and equitable treatment' standard, which is expanding in what appears to be an unbridled manner. Though it is important to protect the rights of the investors under BITs, especially since they are subject to the sovereign powers of a State while making an investment, it is equally important to keep in mind the obligations that a State may have towards execution of its functions. While interpreting the standard, tribunals must strike the right balance.

<sup>1</sup> ICSID Case no. ARB/08/8; award dated March 1, 2012, excerpts published on May 1, 2013.

<sup>2</sup> ICSID Case No. ARB/06/3; award dated May 6, 2012

<sup>3</sup> Please refer to 'Fair and Equitable Treatment', UNCTAD Series on Issues in International Investment Agreements II, 2012, UNCTAD/DIAE/IA/2011/5

<sup>4</sup> Art 2(1) of the Germany-Ukraine BIT states that "Each Contracting Party shall in its territory promote as far as possible investments by nationals or companies of the other Contracting Party and admit such investments in accordance with its respective laws. It shall in any case accord investments fair and equitable treatment."

<sup>5</sup> Article 4(2) of the BIT states that "[i]nvestments by nationals or companies of either Contracting Party shall not be expropriated, nationalized or subjected to any other measure the effects of which would be tantamount to expropriation or nationalization in the territory of the other Contracting Party except for the public benefit and against compensation."

<sup>6</sup> Article 3(1) of the BIT states that "Each Contracting Party shall ensure fair and equitable treatment of the investments of investors of the other Contracting Party and shall not impair, by unreasonable or discriminatory measures, the operation, management, maintenance, use, enjoyment or disposal thereof by those investors. Each Contracting Party shall accord to such investments full physical security and protection."

<sup>7</sup> White Industries Australia Limited v. The Republic of India, UNCITRAL, Final Award dated 30 November, 2011

<sup>8</sup> Deutsche Bank AG v. Democratic Socialist Republic of Sri Lanka (ICSID Case No. ARB/09/2), Award, 31 October 2012; Bosh International, Inc and B&P Ltd Foreign Investments Enterprise v. Ukraine (ICSID Case No. ARB/08/11), Award, 25 October; Joseph Charles Lemire v. Ukraine (ICSID Case No ARB/06/18), Decision on Jurisdiction and Liability, 14 January 2010 2012

<sup>9</sup> Fair and Equitable Treatment, UNCTAD Series on Issues in International Investment Agreements II, 2012, UNCTAD/DIAE/IA/2011/5, pg. 91

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