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Major Pitfalls for Foreign Investors in Russia: What Are Russian BITs Worth?

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Over the past few months, Russia's outgoing Prime Minister Vladimir Putin has been busy campaigning for foreign investment into various industries of the Russian economy. In a nutshell, the thinking behind the new plan for improving the investment climate in Russia is that easing access to strategic industries for foreign investors will do the trick. However, no proposals have been made to increase the level of investor protection in case a deal falls apart.

While it is dubious that better access to the mousetrap gives much comfort to the unlucky mouse caught in it, bilateral investment protection treaties (BITs) provide arguably the only tools "to open the mousetrap" in the context of an investor-state dispute.

This post aims succinctly to identify some of the most problematic areas for investor protection, which are rooted in the wording of Russian BITs.

(Non-) Arbitrability of disputes over the occurrence of expropriation

Most Russian BITs contain a dispute resolution clause limiting jurisdiction of arbitral tribunals to hear disputes over the fact of expropriation.

For instance, the German-Russian BIT sets forth that "a dispute relating to the *amount* of compensation or the *method* of its payment" may be referred to an international arbitral tribunal by either party. An unofficial English translation of Article 10 of the Soviet Union-Belgium/Luxemburg Economic Union Treaty provides that "any dispute between one Contracting Party and an investor of the other Contracting Party concerning the *amount* or *mode of compensation* to be paid" can be submitted to the Arbitration Institute of the Stockholm Chamber of Commerce or an ad hoc tribunal.

Read narrowly, the dispute settlement clauses quoted above exclude claims concerning the occurrence of expropriation from the mandate of arbitral Tribunals constituted under the relevant BITs. Strict construction leads to the conclusion that no claim over the amount or mode of payment may be entertained absent a national court decision on the occurrence of expropriation or an acknowledgement of the host state to that effect.

The *Berschader* Tribunal seems to have followed this logic as it declared that it was "satisfied that *the ordinary meaning* of the [dispute resolution] provision [contained in the Russia-

Belgium/Luxemburg BIT] excludes from the scope of the arbitration clause: … (ii) disputes concerning whether or not an act of expropriation actually occurred".

The Tribunal in this case failed to have reasonably expounded this affirmation. The mere observation "*it can only be assumed* … that a dispute concerning whether or not an act of expropriation occurred [is] to be submitted to dispute resolution procedures provided for under the applicable contract or alternatively to the domestic courts of the Contracting Party in which the investment is made" is unpersuasive.

Although the *Berschader* Tribunal considered the issue of (non-) arbitrability of an act of taking under the Russian-Belgium/Luxemburg BIT *obiter*, restrictive interpretation of a dispute resolution clause appears to gain traction in investment jurisprudence.

The Tribunal in *RosInvestCo UK Ltd. v. Russia* dealt with the dispute resolution provision contained in Art. 8 of the UK-Soviet Union BIT conferring jurisdiction over "any legal disputes … in relation to an investment of the [investor] either concerning the *amount* or *payment* of compensation … or concerning any other matter consequential upon an act of expropriation." The arbitrators in this case concurred with the *Berschader* panel on non-inclusion of controversies over the occurrence of expropriation and its lawfulness in the scope of a respective dispute resolution clause. However, the *RosInvestCo* Tribunal upheld its jurisdiction on MFN ground.

Narrow reading of similarly drafted dispute settlement clauses in Russian BITs yields preposterous results, turning a state – party to a dispute with an investor – into a judge in its own case. Should the host state deny that an act of taking occurred, an investor will be left with virtually no remedy to recover his losses. Is it what drafters of Russian BITs really meant?

In *Renta 4 S.V.S.A. et al. v. Russia* the Tribunal rejected the flawed logic of restrictive construction, having restated the problem as follows: "The Claimants allege expropriation. Russia denies any obligation under this head. There is therefore a dispute as to whether compensation is *due*".

The arbitrators declined Russia's submission on restrictive interpretation of the Spain-Russia BIT's dispute resolution clause providing the following reasoning: "Russia considers that the words "amount or method of payment" allow nothing but a narrow debate about quantum or timing and currency. Even that might leave a door open to say that "amount" includes "no amount" (e.g. because the asset has nil value or because no expropriation has occurred)."

The Tribunal dispensed with the Respondent's argument of non-inclusion of the occurrence of expropriation in the arbitration scope under the Spain-Russia BIT by establishing that an act of taking is indeed a "predicate to any amount being due".

The arbitrators offered the following explanation: "Russia argues that there is no dispute as to quantification … The flaw in Russia's argument is that there is more than one basis on which a respondent State could say "zero". One might be indeed a divergence as to quantification. Another could be a denial of any obligation on account of alleged expropriation … Such an obligation is the evident predicate to any amount being "due" and thus the object of the type of debate allowed under Article 10."

The Tribunal's stance on jurisdiction over claims of expropriation in *Renta* sits comfortably with the principle of effective interpretation, living up to the investors' legitimate expectations. However, the victory of the common sense over the formalistic approach is not sealed yet.

MFN clause as a second chance for investor

By including a Most Favored Nation clause into the body of BITs, Contracting parties seek to extend the application of benefits granted to nationals of third states to nationals of a Contracting partner. MFN clauses traditionally contain the word "treatment" that pertains to the bundle of substantive and arguably other rights and privileges. Controversy exists as to whether an arbitration provision is encompassed within the term "treatment".

The *RosInvestCo* Tribunal answered this question in the affirmative. The Claimants invoked a generously drafted dispute resolution clause contained in the Denmark-Russia BIT by operation of an MFN provision of the Russia-UK BIT. The Tribunal accepted jurisdiction opining that: "As seen … the provision [of Art. 3] grants MFN-protection for "investors" … regarding their management, maintenance, use, enjoyment or disposal of their investments … It is difficult to doubt that an expropriation interferes with the investor's use and enjoyment of the investment, and that submission to arbitration forms a highly relevant part of the corresponding protection for the investor … in case of interference with his "use" and "enjoyment".

The arbitrators in *Berschader* have approached the issue of the applicability of an MFN clause to dispute resolution in a different way. The Tribunal referred to the *Maffezini* Award stating 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."

The *Berschader* Tribunal found no evidence of the Contracting Parties' intention to that effect.

Without plunging into detailed analysis of the two approaches to operation of an MFN clause in regards to an arbitration provision, suffice it to say that finding of jurisdiction on MFN ground is highly case sensitive.

Indirect investments and investor status

Use of various types of "investment vehicles" and "investment conduits" has become common occurrence over the past decades. However, the wording of BITs concluded by the Soviet Union does not always accommodate modern methods of investing in a foreign economy.

Art. 1 of the Russia-Belgium/Luxemburg BIT sets forth that "the term "investment" also means indirect investments made by investors of one of the Contracting Parties in the territory of the other Contracting Party by the intermediary of an investor of a third state".

Plain reading of this provision warrants the conclusion that an investment made by an investor through its intermediary incorporated in one of the states parties to the BIT does not enjoy protection under the Treaty.

Belgian nationals Vladimir and Moise Berschader were sole shareholders of the company Berschader International S.A. (BI) incorporated in Belgium. BI participated in the tender process for construction of new facilities of the Supreme Court of the Russian Federation and ultimately won it. Seven years later the contract was annulled by the Administration of the President of the Russian Federation. The BI's personnel were physically ejected from the construction site. In the Supplemental Agreement the parties to the conflict agreed that the Supreme Court owed US $ 5, 673, 763 to BI. Subsequently, BI received around 6 per cent of the agreed amount. In the following

two years BI was placed on bankruptcy.

The shareholders filed claims under the applicable BIT on their own behalf. Again, the Tribunal construed the BIT *verbatim* and found that the Claimants' investments fall outside the ambit of the Treaty protection because BI was not incorporated "in a third state". The decision was not unanimous as one of the arbitrators dissented.

Sedelmayer v. Russia provides a positive contrast to the unfortunate fate of the *Berschader* case. The *Sedelmayer* Tribunal found no difficulty in dispensing with Russia's contention that Mr. Sedelmayer may not be deemed an investor under the USSR-Germany BIT for he has not made any investments in the Respondent's territory.

Unlike the Claimants in *Berschader*, a national of Germany Franz Sedelmayer operated through the fully owned company SGC International, a juridical person under US law. The USSR-Germany BIT does not place any limitations on the investment vehicle nationality. It is therefore not the libertarian approach of the arbitrators to treaty interpretation but rather the language of the USSR-Germany BIT that secured the treaty protection for indirect investments.

The Foreign Investment Advisory Council's official website (www.fiac.ru) apparently does not seek to increase awareness of the legal pitfalls lying in wait for current and potential foreign investors in Russia. A quick look at history reveals the Russian state to be continuing the legal traditions of the Soviet Union as it appears averse to the idea of being summoned to court or its equivalent let alone being held responsible for its actions. However, keeping this in mind and structuring investments in a sophisticated way might help stave off some legal problems before they arise. To put it bluntly, it is no crime to get smart about BIT-shopping.

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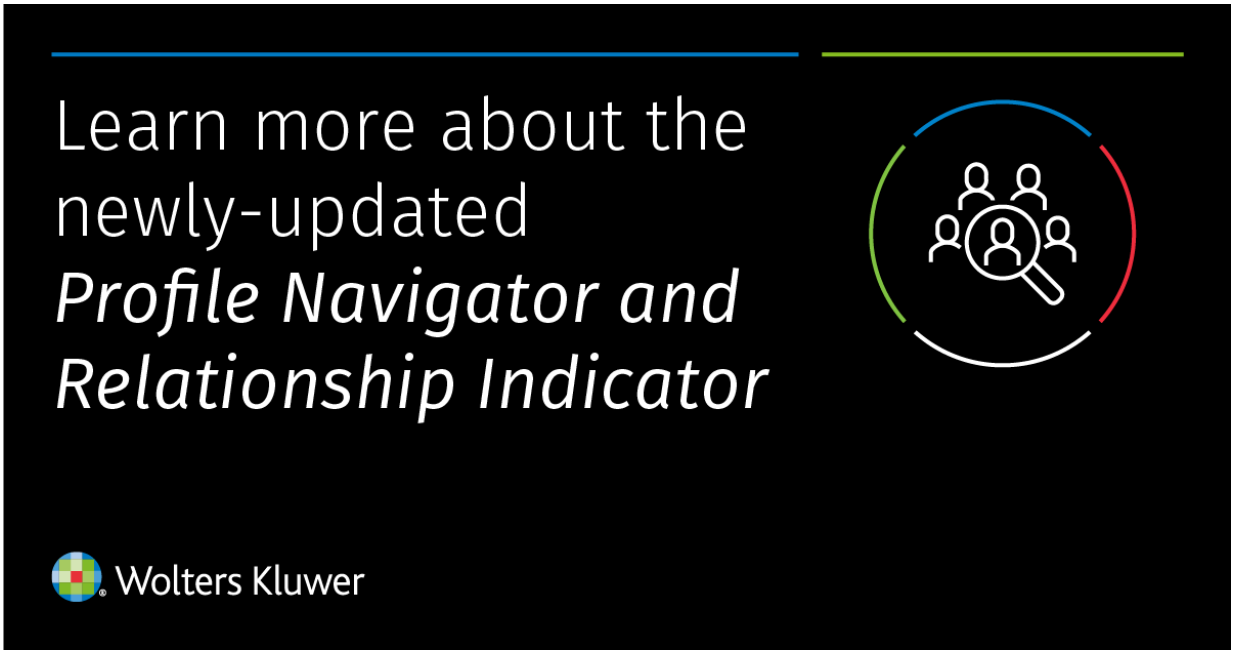

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