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Drawing a Line: Corporate Restructuring and Treaty Shopping in ICSID Arbitration

Inna Uchkunova (International Moot Court Competition Association (IMCCA)) · Wednesday, March 6th, 2013

Akbar the Great once drew with his royal hand a line in the sand. He then told his wise men that if they wanted to keep their jobs, they must invent a way to make the line shorter without touching any part of it. Wise man after wise man approached the line and stood in dismay. No one else but Birbal came with the solution. He stepped forward and drew another line in parallel to the first one, but drew it longer than it. Everyone in the court agreed that the line drawn by the King was shorter and untouched. (A koan)

Foreword: In the eyes of a taxpayer

In the past two weeks civil unrest erupted in Bulgaria causing the Government to step down as a result of the energy prices increase. Protesters demanded termination of the power-distribution contracts concluded with foreign-owned companies. The present post seeks to examine the situation of an investor whose investment is threatened but he does not have access to ICSID arbitration. Is corporate restructuring an option?

For this purpose, treaty-shopping may be defined as the process of routing an investment so as to gain access to a BIT where one did not previously exist or for gaining access to a more favorable BIT protection. The focus is on restructuring by transfer of shares or otherwise at the time when the investment is already under some threat such as in the case of a revocation of a license or termination of a contract.

First, it must be stated that treaty-shopping is not, in principle, prohibited under international investment law, as the purpose of BITs is exactly encouragement of investment. (See *CME Czech Republic B.V. (The Netherlands) v. The Czech Republic*, Partial Award of 13 September 2001 (UNCITRAL Arbitration Proceedings) at para. 419; cf. *Mobil Corporation, Venezuela Holdings, B.V. et al. v. Bolivarian Republic of Venezuela*, ICSID Case No. ARB/07/27, Decision on Jurisdiction dated 10 June 2010 at para. 204)

Secondly and by way of admission, the *Aguas del Tunari, S.A. v. Republic of Bolivia* case (ICSID Case No. ARB/02/3, Decision on Respondent's Objections to Jurisdiction dated 21 October 2005) is a strong case for investors in a situation similar to the above described, although it must be noted that every case of alleged abuse of process must be judged on its own circumstances.

The topic of nationality planning has been recently examined by Prof. Schreuer. He has concluded

that:

> "[t]he validity of nationality planning [is] primarily dependent on the time of the restructuring in relation to the dispute. If the restructuring was undertaken early i.e. before the outbreak of the dispute, the newly acquired nationality will be honoured. But a last minute change of nationality in the face of an existing dispute will be rejected." (Schreuer, C., *Nationality Planning*, Fordham Conference, London, 27 April 2012. Revised 12 October 2012, https://www.univie.ac.at/intlaw/wordpress/wp-content/uploads/2012/11/nationality-Planning-Fordham-revised.pdf, p. 18)

In the above-mentioned *Aguas del Tunari, S.A. v. Republic of Bolivia*, after a water and sanitary sewer concession contract was concluded, the so-called "water war" started in 1999 and local population demanded termination of the contract out of fear that prices will skyrocket. In the meantime, Aguas del Tunari changed its upstream ownership by transferring 55% ownership stake to a Dutch company in December 1999. (This is only briefly stated. For more details see the case itself and also de Gramont, A., *After the Water War: The Battle for Jurisdiction in Aguas Del Tunari, S.A. v. Republic of Bolivia* in 3 TDM (2006)). Four months later the concession was terminated. The tribunal thus accepted that at the time of restructuring the investor could not have contemplated the events which followed in the spring of 2000 and concluded that *in casu* the restructuring did not amount to abuse of process. Similarly, in *Mobil v. Venezuela* the tribunal distinguished between the already existing disputes relating to royalty payment and income tax payment and a future one relating to the termination of the concession. Only in the latter hypothesis was the restructure legitimate. (paras. 204-205.) Notably, in this case the process of restructuring started three years before the nationalization. (para. 203)

For the sake of clarity, the cases of *Tokios Tokel?s v. Ukraine* (ICSID Case No. ARB/02/18, Decision on Jurisdiction, 29 April 2004), *Phoenix Action, Ltd. v. The Czech Republic* (ICSID Case No. ARB/06/5, Award of 15 April 2009) and *Pac Rim Cayman LLC v. The Republic of El Salvador* (ICSID Case No. ARB/09/12, Decision on the Respondent's Jurisdictional Objections of 1 June 2012) must be distinguished. The first concerns restructuring which took place six years before the entry into force of the BIT in question (para. 56), the second – downstream reorganization upon already existing dispute (para. 95), and in the third case, the State led the investor to believe that the withheld permits will be eventually issued (para. 2.83.).

These important distinctions may serve to emphasize that the question remains largely unsettled and that *Aguas del Tunari, S.A. v. Republic of Bolivia* case might not serve as a powerful 'precedent' for future tribunals. Already in the *World Duty Free v. Kenya* case the tribunal recognized that "law protects not the litigating parties but the public; or in this case, the mass of tax-payers and other citizens making up one of the poorest countries in the world." (*World Duty Free Company Limited v. Republic of Kenya*, ICSID Case No. ARB/00/7, Award of 4 October 2006 at para 181.)

I am looking into this question with the eyes of a tax-payer and – more importantly – of a citizen of Europe's poorest country. I am therefore arguing that treaty-shopping in the above described situation amounts to abuse of process and thus an ICSID tribunal will lack jurisdiction to consider the claim. Nonetheless, I admit that, given the considerable uncertainty prevailing at the time, a

strong case can be made for the legitimacy of such restructuring.

I. The case "against" lawfulness of corporate restructuring

1. Restructuring of the investment does not qualify as a protected investment as it is made in violation of the host State's law

My first thesis is that restructuring made closely following the first of a series of acts which form the dispute between the parties may not constitute a covered investment as being established contrary to the laws of the host State. Whether the BIT contains or not a requirement that the investment shall be established in accordance with the law of the host State, tribunals have concluded that a BIT "leaves investments made illegally outside of its scope and benefits." (See *Inceysa Vallisoletana S.L. v. Republic of El Salvador*, ICSID Case No. ARB/03/26, Award of 2 August 2006 at para. 206; See also Smutny & Polášek, *Unlawful or Bad Faith Conduct as a Bar to Claims in Investment Arbitration* in Werner & Ali (eds.) *A Liber Amicorum: Thomas Wälde Law Beyond Conventional Thought* (Cameron May 2009) pp. 277-296)

Many, if not all, municipal laws contain a prohibition against circumvention of law. On this ground, it may be argued that the investment was established in violation of this prohibition and is thus outside the scope of the host State's consent. Should this not be accepted as a valid ground for dismissing the Claimant's claims there are two alternative arguments as it follows.

2. Restructuring of the investment does not qualify as a protected investment as it does not meet the requirement of "contribution to the host State's development"

From the intention behind the investment in the midst of a growing dispute it would be obvious that the investment is not made with the purpose of contributing to the host State's development. This requirement for determining the existence of an investment is, admittedly, controversial. (Schreuer, C. et al., *The ICSID Convention: A Commentary* (Cambridge University Press, 2nd edn 2009) at pp. 131-134) However, in the circumstances, such a factor cannot be left out of account, especially when combined with the requirement of duration. The tribunal in *Phoenix Action, Ltd. v. The Czech Republic* held that "This alleged investment was not made in order to engage in national economic activity, it was made solely for the purpose of getting involved with international legal activity." (para. 142)

3. Restructuring of the investment does not qualify as a protected investment as it does not meet the requirement of "duration"

Prof. Schreuer in his Commentary on the ICSID Convention has identified the requirement of certain duration as one of the elements to be taken into account in determining the existence of an investment. He has observed that "Tribunals seem to have regarded a period of two to five years as sufficient." (p. 130) In consequence, when a claim is presented shortly after the restructuring has taken effect it becomes apparent that the investment is made for the sole purpose of gaining access to ICSID arbitration and amount to an abusive manipulation of the system of international investment protection.

II. The case "for" foresight in corporate restructuring: Foreseeability v. the fact "which really gave rise to the dispute"

Most recently, the tribunal in *Pac Rim Cayman LLC v. The Republic of El Salvador* held that:

> "[T]he dividing-line occurs when the relevant party can see an actual dispute or **can foresee a specific future dispute** as a very high probability and not merely as a possible controversy. In the Tribunal's view, before that dividing-line is reached, there will be ordinarily no abuse of process; but after that dividing-line is passed, there ordinarily will be. The answer in each case will, however, depend upon its particular facts and circumstances, as in this case." (para. 2.99.)

Irrespective of how ambiguous this dividing line is, the tribunal laid emphasis on the **foreseeability of the dispute**. This implies that should subsequent tribunals adopt a first-fact approach (i.e. after the first in a series of facts giving rise to a dispute has taken place), an after-the-fact restructuring will amount to an abuse of rights and such an investment will not be covered by the consent of the host State. As in the story of Akbar mentioned at the beginning of this post, investors shall not be allowed to draw a longer line which would completely blur the limits between legitimate nationality planning and manipulation of the ICSID dispute settlement system.

In the interest of fairness, however, I shall mention that when dealing with limitations *ratione temporis* in declarations of acceptance of its jurisdiction excluding facts of situations occurring prior to the date of the declaration, the Permanent Court of International Justice has held that it must look at the "the facts which really gave rise to the dispute." (*Phosphates in Morocco*, Judgment (Preliminary objections), Permanent Court of International Justice Series A/B No. 74 (1938) at p. 26) In the *Electricity Company of Sofia and Bulgaria* case the Court added that

> "it is true that a dispute may presuppose the existence of some prior situation or fact, but it does not follow that the dispute arises in regard to that situation or fact. **A situation or fact in regard to which a dispute is said to have arisen must be the real cause of the dispute.**" (See Judgment (Preliminary objections), Permanent Court of International Justice Series A/B No. 77 (1939) at p. 82; This approach has been upheld by the International Court of Justice in *Case concerning Right of Passage over Indian Territory* (Merits), Judgment of 12 April 1960 I.C.J. Reports 1960, p. 34)

Under this analysis, it cannot be maintained (however repulsive this might seem in the eyes of a tax-payer) that the protests in the above scenario currently unfolding in Bulgaria are the real cause of the dispute. Only the subsequent termination of the contracts will lead to the crystallization of the dispute. Thus, restructuring prior to termination would be legitimate.

On the other hand and as far as continuing wrongful acts are concerned, the decision in *Pac Rim Cayman LLC v. The Republic of El Salvador* contains an important finding:

> "**Where the alleged practice is a continuous act** …, this means that the practice started before the Claimant's change of nationality and continued after such change. This analysis would found the basis of the Tribunal's jurisdiction ratione temporis under CAFTA; but **it would preclude the exercise of such jurisdiction on the basis of abuse of process if the Claimant had changed its nationality during that continuous practice knowing of an actual or specific future dispute, thus**

> **manipulating the process** under CAFTA and the ICSID Convention in bad faith to gain unwarranted access to international arbitration." (para. 2.107.)

The same reasoning would apply to composite acts (See Article 15 of the ILC's Articles on Responsibility of States) in which category falls for example creeping expropriation. A temporary interference, for its part, (such as temporary closure of a State's border which obstructs the operations of an investor) will fall into the category of completed acts. Likewise, the Commentaries to the ILC's Articles on Responsibility of States point out that "[a]n act does not have a continuing character merely because its effects or consequences extend in time." (Comm. 6 to Article 14 of the ILC's Articles on Responsibility of States)

The present post does not concern itself with the question of denial of benefits clauses found in some BITs. States are, however, well advised to include in contracts with investors a requirement of prior notification so as to be aware of the consequences. Or, if this requirement is not observed, this may well serve as evidence of bad faith. Additionally, in cases of internationalization of a domestic dispute, i.e. when a national of the State opts for a nationality of convenience in the face of a growing or already existing dispute this shall be deemed per se an abuse of rights. (See also *Cementownia "Nowa Huta" S.A. v. Republic of Turkey*, ICSID Case No. ARB(AF)/06/2, Award of 17 September 2009 at para. 117)

A look into the future

A case of interest which may shortly test the above propositions is *Philip Morris v. Australia*. Immediately after Australia committed to introduce plain packaging legislation in 2010 Philip Morris Limited acquired shares in PM Australia and thus, it was alleged, the company was able to "buy into a dispute [which] is either existing or highly probable." (*Philip Morris Asia Limited v. The Commonwealth of Australia*, PCA Case No. 2012-12 (UNCITRAL Rules 2010), Procedural Order No. 4 Regarding the Procedure until a Decision on Bifurcation of 26 October 2012 at paras. 29-30.) Under the timetable of proceedings the Claimant is to file its Statement of Claim by 28 March 2013.

Whichever of the above approaches prevails in the future, it is with a view to legal certainty that arbitrators must take their decisions. Ideally, preventing abusive claims will foster a climate of mutual trust between investors and host States which is as important in the XXI century as it was in the era when foreign protection law emerged. Otherwise, States may be encouraged to denounce the ICSID Convention or to take outright measures such as abrupt termination of contracts in the face of a growing dispute.

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